



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 High Income Equity Portfolio (HIEP) continued to provide steady capital appreciation and income in the first quarter of 2017 following a solid year in 2016. The HIEP Composite was up 3.2%¹ in the first quarter and is up 8.0% on an annualized basis since its inception in 2010. These returns were achieved even though the portfolio is designed to weather market disruptions, and over time has taken 30% less risk than the market² while generating a current yield of 3.9%, double that of the S&P 500 (which yields 1.9% as of March 31).

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 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.

¹ The performance noted is for the GCM High Income Equity Portfolio 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.

² We measure risk in terms of volatility as measured by Beta, a standard statistical measure.



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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 allowing our fixed income/floating rate securities to contribute 1% to performance. 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.

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.³ 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.

The mandate of the HIEP is to preserve capital, provide income and appreciate over time. In order to do this, we employ a barbell strategy. We manage part of the portfolio extremely conservatively, with about a third of the portfolio in preferred stocks or stocks with fixed income-like characteristics. The other part of the barbell consists of common stocks. Some are conservative equities with above average, and rising yields. A smaller amount are shares in investment grade companies with low or no dividends that we think are worthwhile appreciation candidates. Over time, this barbell approach has worked well, allowing above average income, below average volatility and decent appreciation (again, about 8% a year since 2010).

Our solid performance in the growth-driven first quarter underscores the benefits of that approach. We don't own "the market," we own interests in about 25 attractive companies. It very much matters which ones we choose. For example, we don't own much technology – only two companies – but one of them, **Apple**, surged 24% in the first quarter, greatly helping performance. Again, showing the value of "concentrated diversity" (having large positions but across a variety of economic sectors), our top five performers were all from different industries: technology (**Apple**), basic materials (**Weyerhaeuser**), healthcare (**Pfizer**), media (**Comcast**) and finance (**Mastercard**). Of course, the math works in both directions: Our large exposure to the energy sector, which contributed nicely to performance in 2016, cost us about a percent in the quarter as oil prices fell and the stocks declined in a rising market. We have several high yielding, investment grade oil companies, (**Shell**, **Chevron**, **Occidental**), and they were all down in the quarter.

³ 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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We made a new investment in **Crown Castle International** in the first quarter. This is a company that buys land, builds cell towers and leases “slots” to various cellular telephone providers (like AT&T or Verizon). These are long term leases, and once the first tenant is secured, it costs very little to add a second site to the tower. It is an established but still growing business with an investment grade balance sheet and a 4% yield. The company’s growth, its high yield and the stability of the business fit well in the high income equity portfolio.

A company that is on the appreciation side of the barbell would be our new investment in **Gilead Sciences**. Gilead sports a 3.1% yield and an investment grade balance sheet, yet we purchased the stock recently, down more than 40% from its highs of two years ago. The reason is that its Hepatitis C medicine has cured the first batch of patients, and sales are declining, both because less urgent patients will come next and several competitors have entered the market. These headwinds are real, but we think they have been exaggerated by investors, and the stock is now selling at less than seven times this year’s projected earnings, a 60% discount to the market. Investments like Gilead may be multi-year projects, but with a safe dividend, we will get paid to wait for a favorable outcome. Recall that our average holding period for an investment is three to four years. Specific opportunities take time to mature but can be extremely lucrative. That’s why we make room for several of them at any given time in the HIEP.

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