



Grisanti Capital Management

October 11, 2017

Dear Clients & Friends of Grisanti Capital Management:

The Grisanti Capital Management High Income Equity Portfolio performed well in the third quarter, rising 3.7%. Currently, the portfolio yields 3.6% (and historically has averaged almost 4%) and is structured to have a significantly lower volatility than the market as a whole. In quarters like this one, that low volatility doesn't matter much. In fact, as we discuss below, this has been the least volatile market period in more than 50 years. But obviously, it won't always be that way.

The HIEP reminds us of an athlete who can win the decathlon, even though he doesn't finish first in any one category. The HIEP employs a barbell approach to combine certain safe, fixed income-like securities with stocks that should appreciate over time. The stocks themselves are divided into income-producing steady growers and more aggressive appreciation candidates. In a rising rate environment, this mix should nicely outperform a bond portfolio, yet it has a consistently higher yield than the over-all market or the ten-year bond. It is significantly less volatile than the market, and in a downturn, it should protect your capital considerably better than a more market-based equity portfolio. Finally, the equity portion creates the opportunity for some appreciation in years like this one. When it's sunny out, no one thinks about umbrellas, but we like to say the HIEP is an all-weather portfolio.

One of the features that separate the HIEP from an ordinary high income portfolio of blue chip stocks is our hybrid fixed income instruments. We are currently utilizing certain preferred stocks and bonds of investment grade companies that have floating (instead of fixed) rate features. This combination allows them to offer fixed income advantages to the portfolio, such as higher yields than ordinary stocks, and dampened volatility (again, as compared to equities), while the floating rate feature protects them from downward pressure in a rising rate environment.



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We continue to believe that investors are not being as cautious as they ought to be. It is vital to appreciate that these are not normal times in the market. In fact, they are highly aberrant. So far, 2017 has had the lowest volatility in more than 50 years. We analyzed almost a century of intra-year declines – the largest market decline made during a given year from the year's high to its low. The worst intra-year decline was 49% in 2008. The average is about 11%. This year's intra-year decline (so far in 2017) is 3%, a 50-year low. In other words, the market has done virtually nothing but go up this year. In another measure of low volatility, 2017 has had the smallest number of daily 1% moves in the S&P 500 Index since 1963. Our strong advice would be: Don't get used to the market's steady upward movement. It's weird, and it's risky.

The goals of the HIEP are to preserve capital and provide steady income with capital appreciation. The best way to accomplish that goal is to buy companies that are both well-managed and undervalued (good companies at great prices). These investments might not rise as much as the market in times like these – times of exuberance and low volatility – but, when risk returns, your investments need to have intrinsic value, and not just transient popular acclaim. Otherwise, they can fall dramatically. We report on some of our current holdings and new opportunities below.

One of our best performers for the year has been **Dominion Energy preferred stock**. The security is up over 16% while also sporting a greater than 5% yield and exhibiting much less volatility than a common equity due to its fixed-income type properties. After the presidential election in 2016, interest rates spiked, causing some preferred stocks to become mispriced. This created our opportunity for purchase. As interest rates stabilized, Dominion Energy preferred shares appreciated in value as the issuer, a manager of power plants, has an investment grade balance sheet and is rich in cash flow. We continue to monitor the market for mispriced assets such as these, that can both increase income and reduce portfolio risk.

Another strong performer in the quarter was a classic example of a value investment. **Gilead** is a pharmaceutical company with lots of cash, a cure for Hepatitis C, and a really low valuation (7 times earnings, versus a market that is at 18 times). The reason for the low valuation is that its hepatitis C drug faces increased competition and sales are falling. We believe this bad news is already reflected in the low share price (down 47% from its high). The company has smart management and (we never tire of mentioning) lots of cash. In the third quarter, management decided to use \$10 billion of that cash to buy Kite Pharmaceuticals, a company on the cutting edge of Cell Therapy, a last defense cancer therapy that removes, re-engineers and re-inserts patients' cells, now equipped to fight that specific cancer. It's a drastic therapy, but it has miraculous cure rates in cases that were almost certainly terminal. Another benefit of the company's cash is an above-market dividend yield of 2.5%. We believe this investment is illustrative of how we can balance both capital appreciation (buying inexpensive securities) with income in the form of stable or growing dividends. The stock rose 15% in the quarter, but still remains cheap at 9 times earnings.



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A stock that detracted from portfolio performance in the quarter was **Disney**, down roughly 5% since our initial purchase. Shares continue to be under pressure as investors weigh the effects of consumers choosing smaller cable packages and direct-to-consumer products such as Netflix, over the traditional bulky “bundles” of many channels. We continue to believe that Disney’s content, especially its sports network ESPN, give the company a competitive advantage over its rivals. Due to its quality and breadth, we think consumers will demand Disney content regardless of what platform it is delivered on. Trading at just 14 times earnings (a 20% discount to the market), we believe investors are mispricing the depth of the company’s business, which spans beyond cable to a very successful movie business (including the Star Wars and Marvel franchises) and theme parks. With a compelling film slate and park expansions, we believe these segments position the entire company well for strong growth in 2018 and beyond.

To reiterate our earlier point, these are not normal times. Investors are increasingly shrugging off high valuations, as companies we view as already expensive rise even further. If history is any guide, this may continue for some time. However, we remain committed to our strategy of not chasing short term performance at the expense of portfolio risk. The HIEP is an ideal vehicle for participating in some of the market’s upward trajectory while remaining defensive. No one knows for sure when it will be worthwhile to be prudent rather than bold, but in the ninth year of an aging economic expansion, and with a host of issues facing investors, we think precautions are warranted.

We look forward to writing you again at the end of the year.

Very truly yours,

Christopher C. Grisanti