



Grisanti Capital Management

January 18, 2018

Dear Clients & Friends of Grisanti Capital Management:

The GCM High Income Equity Portfolio (HIEP) delivered both steady capital appreciation and income throughout 2017, rising 4.2% during the fourth quarter and 12.7% for the year.¹ The year-to-date gain was accomplished while taking nearly 30% less risk than the market² and generating an average yield of nearly 3.7%, about twice that of the S&P 500. 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 2017 even though the low volatility of a steadily rising market in 2017 was not the optimal environment for the defensive structure of the HIEP. We believe 2018 may be a more difficult period, even if the economy stays healthy, simply because (as we discuss below) 2017 was the least volatile year in more than half a century.

The fourth quarter was strong for the overall market as the Trump Administration and Congress finally brought their much talked about tax bill to the finish line. So far in 2018, the enthusiasm has continued, with the new year starting out strongly. Apart from new tax legislation, which reduces the domestic corporate tax rate to 21%, the world is experiencing synchronized economic growth for the first time in more than a decade. In the United States, unemployment is low at 4.1%, and interest rates, albeit somewhat higher than previously, remain benign. Workers' wages are moving up slowly and companies are increasing their capital expenditures. These conditions should provide a supportive backdrop for equities in 2018.

However, as managers of the HIEP strategy, we are also aware that market downturns can happen at any time, taking most investors by surprise. To complacent investors, a change in market sentiment – whether due to specific events, for unknown reasons or for no reason at all – can be destructive. In 2017, the market was aberrantly calm, suffering no significant setbacks the entire year. The chart below shows that by year-end 2017, 381 trading days had passed since the market last declined by more than 5% from its peak. As I write this letter, we are just a few days from surpassing the all-time streak of 394 days, which will occur on January 23rd (absent an unlikely 5% decline before then). As it is, there have only been four such long streaks since the 1920's. We are not expecting a market downturn, but rather, if history is any guide, we can

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.

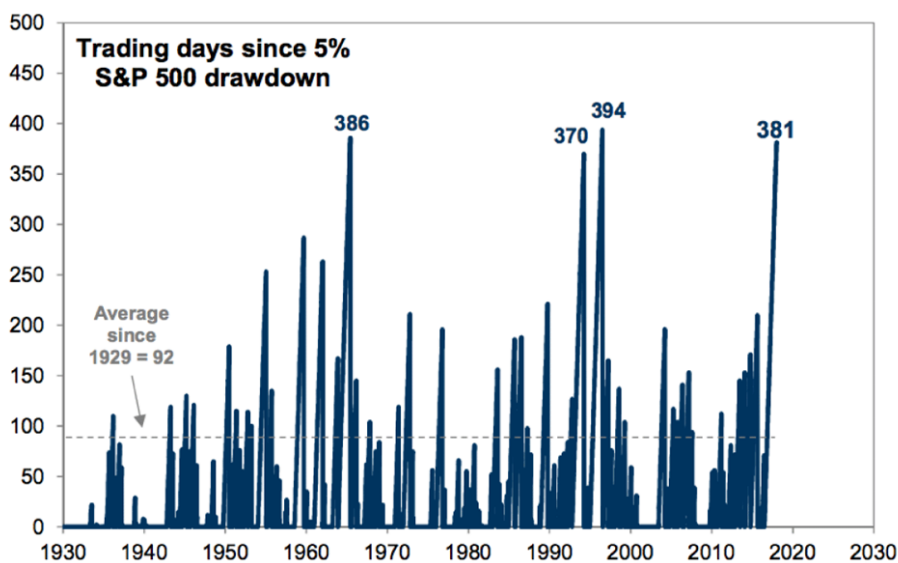
² As measured by Beta, a commonly used statistic for measuring volatility compared to the market.



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expect more turbulence in the future than we've had in the previous year. While we don't desire more volatility, we take some comfort that choppy market conditions are what the HIEP is designed for.

Exhibit 1: 381 trading days since last 5% S&P 500 drawdown
as of December 29, 2017



Source: Goldman Sachs Global Investment Research.

Conceptually, the HIEP is constructed as a barbell, with each side designed for one of the portfolio's core objectives, safety and income on one hand, and capital appreciation on the other. When combined, we believe the two sides of this barbell strategy provide for the preservation of capital with steady income, and the potential for capital appreciation.

As part of this strategy, we hold between 20-25% of non-common-equity securities that greatly reduce the portfolio's volatility. Currently these are mostly *floating rate preferred stocks*, with high dividends, issued mostly by investment grade companies (like JP Morgan or American Express). We have opted for *floating rate* preferreds as opposed to fixed rate, even though the dividends can be slightly lower. This is because in the current rising rate environment, these securities are insulated from price declines as their dividend *increases* with rising rates. In the face of an equity market disruption, these securities have historically held their value as investors are attracted by their relative safety.

One investment that performed well in the fourth quarter of 2017 was **Wells Fargo**, (up about 10%). If you recall, we purchased shares of the bank in the wake of its account fraud scandal. Although we were disappointed with the actions of certain parts of the bank, we were also aware of the company's decades' long track record of strong returns and competent management. We viewed the sharp move down in its share price as an opportunity. The company conducted a full scale review and is well on its way repairing relationships with



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customers and adopting more stringent internal controls. In addition, the company will be a strong beneficiary of the lower corporate tax rate in the United States. With economic conditions healthy, rising rates (which help banks by increasing their margins), and an attractive valuation, we continue to view Wells Fargo as an attractive investment opportunity.

Our top performer of 2017 was **Apple**, up 41% for the year. The stock outperformed the market as the company launched its latest handset iteration, the iPhone X (pronounced “iPhone Ten”), and investors continued to increase their focus on the company’s services business. The Apple Services business is comprised of many applications that customers use every day like Apple Music, Apple Cloud, the App Store and Apple Pay. This business is considerably more stable than selling handsets, because for example, a new app invented today can be purchased on iPhones bought years ago. The service business provides steady cash flow that can be used to return to shareholders as well as reinvest in the business. At just 15 times earnings vs the S&P 500 Technology Index at 18 times, we believe Apple stock is still inexpensive. The company’s strong balance sheet (\$270B in cash) and ability to grow its dividend continue to justify its position as a core holding of the HIEP.

At the end of 2017, we invested in **Mondelez International**. The company is the maker of several household food brands such as Oreo, Ritz and Cadbury. We believe the stock represents value in the Consumer Staples sector as it trades at a 10% discount to the S&P 500 Index on a price-to-earnings basis. Historically, the stock has traded at a 30% premium. We believe the stock can regain its premium as it continues to grow earnings at double digits. In addition, the company’s brands should continue to generate steady cash flows in times of economic duress, making it a solid defensive holding for the HIEP. With a yield of 2%, we view Mondelez as a good combination of both income and the potential for meaningful capital appreciation.

We have a two part outlook for 2018. Although we believe economic conditions are healthy, the market is clearly extended and aberrantly peaceful. As we enter the 10th year of an economic cycle we will continue to focus on our “barbell” strategy that has served this portfolio well in both strong and weak markets. We look forward to reporting back to you in April.

Very truly yours,

Christopher C. Grisanti