Grisanti Capital Management

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Dear Clients & Friends of Grisanti Capital Management:

"There are no brave old people in finance."
-- Steve Schwarzman, CEO Blackstone Group

At first glance, it paid to be brave in the second quarter of 2017. Investors who boldly bought the most expensive stocks at the beginning of the quarter were favored over all others. But spending your money to buy expensive stocks in the hope that they will become even more expensive has always struck us as a kind of "angels-fear-to-tread" bravery. We agree with Mr. Schwarzman that the more you've seen on Wall Street, the less brave you become. Put another way, those investment managers who have survived to old age did so by avoiding risks that may have paid off in the short term but ultimately left their clients vulnerable.

For better or worse, count us among the non-brave. The market has not been this expensive since the late 1990s. In three years, from 1997 to 1999, the technology rich NASDAQ Index rose over 200%. Valuations escalated to record highs. Then, in the following three years, the bubble burst and that market declined 67%, or two-thirds. Those who were invested for the entire six-year period escaped with minor losses, but most investors were sucked in during the upswing. Because they did not enjoy the initial appreciation, they lost considerable sums. For what it's worth, we lagged the market by a significant amount in 1997-99, but still made a decent return, and then we continued to rise while the market fell in the succeeding three years, because by the time the market peaked we owned no technology (it had gotten too expensive). Overall, our performance at the end of the six years was way ahead of the averages – but at any point in the first three of those years, it looked anemic. At no point was it "brave," but by the end, it was rewarding.

One picture graphically reveals what's happening under the surface of the go-go market. The chart on the next page shows the discrepancy this year between the performance of growth stocks (mostly technology) and value stocks. Right now, growth is trouncing value, and in fact the gap has not been this wide since the height of the tech bubble 18 years ago. As you can see, the S&P 500 Index is simply an average of its growth and value components. While we

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outperformed the value index, we remained behind the S&P 500 Index because of the strong performance of growth stocks.

So why not just buy growth? After all, these periods of euphoria can last for years, and while valuations are high, they are still well short of record levels set in 1999. In general, this amounts to a greater fool argument – buy an already expensive item because you'll be able to pawn it off on the next guy for even more. Again, we're not brave enough for that.

That doesn't mean, however, we're too old to learn new tricks. Technology far outpaced other parts of the market this year. Many of those stocks are now terribly expensive, violating our value parameters. But others still have growth that is more reasonably priced (more akin to 1997 than 1999). We invested in two of those companies this quarter, and they are discussed below. Further, we continue to like our investment in **Apple**, which was a classic value stock when we bought it last year at 12 times earnings, and even now, up almost 50%, remains below the average valuation of stocks in the S&P 500 Index (and far below the average technology valuation).

In summary, before we discuss portfolio details, we are up about 3.3% this year, behind the S&P 500 Index, but ahead of the S&P Value Index, perhaps a more appropriate measure of the kinds of companies we invest your money in. We will continue to make prudent investments, and that means not taking "brave" bets that may continue to work in the short term, but expose you to inordinate risk in the long run.

The economy seems pretty good from where we're sitting. Consumer confidence remains high, while interest rates remain low. The market's momentum makes investors feel

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wealthier; they in turn spend more, and that helps the economy. Like the technology rally, that type of bootstrap phenomenon works until it doesn't, but so far so good. The political landscape remains frustrating and uncertain, but that has made several sectors cheaper than they otherwise would be (healthcare jumps to mind). We are sifting through opportunities and report on some below.

Amgen is the largest and most mature biotechnology company. No longer a one product firm, its drug portfolio and capacity for R&D rivals a major pharmaceutical company. The company's base oncology business is stable and producing strong cash flows allowing Amgen to both increase its returns to shareholders as well as invest in new opportunities. At 13 times earnings, it sells at a 35% discount to the market. We believe investors are giving little credit to products that haven't been launched yet. While we wait for these new opportunities to come to market we collect a growing dividend of almost 3%, protected by a solid balance sheet.

Not all technology is over-valued. **Facebook** recently announced that it now has over 2 billion monthly users, and over the past few years, growth in mobile advertising, which now amounts to 85% of its sales, has been staggering. This exposure has allowed the company to surpass Wall Street expectations for 10 straight quarters. We think this trend will continue and although the stock trades at a slight premium to the market, its visible earnings growth is almost three times that of the S&P.

We also made an investment in **Oracle** this quarter. The company's wide range of database software makes their customers' business processes more efficient. This gives them an important edge in a world increasingly focused on competitive advantages created by technology. As a result, Oracle's corporate clients can be very loyal. Although earnings growth had stalled in the past few years, increasing cloud adoption among its customer base is once again driving earnings growth. The company generates significant free cash flow which should be returned to shareholders in the form of increased dividends and further share repurchases.

Finally, we have returned to a company we have owned successfully in the past, **Disney**. Although earnings growth has slowed somewhat in 2017, we think that the company is well positioned for strong growth in 2018 and beyond. This is due to brand new and expanded theme parks, which make up 30% of the company's total earnings. Shanghai Disney just opened to rave reviews. In addition, the company will shortly debut a powerful two-year film slate that includes both new Star Wars and Marvel's The Avengers films. At under 16 times earnings, the company trades at a 15% discount to the market, while over the past 7 years it has traded at a 10% premium. This discount is largely due to concerns over ESPN, Disney's sports-focused cable channel. As some consumers opt out of traditional cable packages, this has put pressure on the fees Disney receives from cable providers (like portfolio company **Comcast**). We believe, however, that Disney is taking the right steps to reduce costs at the sports network. In addition, ESPN's live sports programming is one of the few TV offerings that is protected from internet streaming services like Netflix that rebroadcast shows – after all, who wants to see the big game a week or a month later?

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The second quarter was a frustrating one for us. Not only did growth trounce value, but we lost money on our energy investments and ultimately eliminated many of them from the portfolio. Most were still winners from their purchase – as a group they were our best performing sector in 2016 – but they have cost us almost 3% in performance so far this year. What we got wrong was the ability of U.S. oil producers to ramp up production even at $45 oil. So now, even at relatively low prices, there is, again, too much oil. We now believe that advances in drilling technology and easily available capital will continue to lead to a surplus of both oil and natural gas for at least the intermediate term.

We do not like lagging a runaway market. Value investing tends to fall behind in such periods, but outperform in tougher times. Since our inception in 1999, the GCM Large Cap Value Composite has appreciated 197%, well ahead of the S&P 500 Index (up 131%).[1] Much of this comes from outperforming in times when the market is struggling. With that in mind, it's important to remember we have entered the ninth year of an economic expansion. The average expansion is only 59 months (about 5 years), and the longest since World War II was 120 months (ten years). The bravest thing to do right now might just be to remain cautious.

Very truly yours,

Christopher C. Grisanti

[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. Performance for the Large Cap Value Composite is shown gross of advisory fees and transaction costs, if any. GCM's advisory fees are described in Part II of its Form ADV. The Composite's benchmark, the S&P 500 Index, includes the reinvestment of income but does not include any transaction costs, management fees or other costs. Past performance is no guarantee of future results.