



Grisanti Capital Management

July 19, 2017

Dear Clients & Friends of Grisanti Capital Management:

Although the current bullish market environment is not what the High Income Equity Portfolio (“HIEP”) is designed for, the portfolio added to gains posted in the first quarter while providing stable income. The HIEP composite is up 4.30%¹ for the year and has an average annual return of 7.90% since inception in 2010. These returns were achieved even though the portfolio is designed to weather market disruptions, and over time has taken substantially less risk than the market² while generating a current yield of 3.7%, almost double that of the S&P 500.

The second quarter of 2017 looked much like the first. Technology stocks continued to rise and investors who bought these expensive stocks were rewarded. This phenomenon has resulted in valuations not seen since the late 1990s. From 1997 to 1999, the technology rich NASDAQ Index rose over 200%. Valuations escalated to record highs until the bubble burst and the market declined 67%, or two-thirds in the succeeding three years. For what it’s worth, our investment style lagged the market by a significant amount in 1997-99, but still made a decent return. Then, we continued to rise while the market fell, because by the time the market peaked we owned no technology (it had gotten too expensive). Periods of ‘irrational exuberance’ challenge conservative investors to stick to their valuation discipline.

The mandate of the HIEP is not to keep up with a runaway market, but rather to preserve capital, and provide steady income with capital appreciation. It is important that we stick to this discipline by investing in companies that create value over time and return it to shareholders. Any attempt to adapt herd behavior ultimately leaves clients vulnerable. We continue to manage the portfolio conservatively, with about a third of the portfolio in preferred stocks or stocks with fixed-income-like characteristics. The remainder of the portfolio is invested in common stocks.

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.



Grisanti Capital Management

A large part of those are conservative equities with above average and rising dividends. A smaller amount are shares of investment grade companies with lower yields that we think are worthwhile appreciation candidates. Over time, this barbell approach has worked well, allowing above average income, below average volatility and capital appreciation.

The overall economy continues to experience slow but steady growth. Consumer confidence is high, and unemployment and interest rates remain low. This has benefited our fixed-income-like securities. In the current low-rate environment, the principal in these investments is worth more as investors search for yield. Keeping this in mind, we are wary of a rising interest rate environment and we continually look for mispriced income assets in order to diversify the portfolio and add stability and income. Separately, valuations in common equity remain elevated driven by the aforementioned technology/growth stocks. However, as investors chase growth, they leave other compelling investments behind. We report on some of our current holdings and new opportunities below.

The portfolio was able to work its way higher due to the stability provided by our fixed-income-like investments and diversification across economic sectors. The best performer of the quarter was **Citigroup**, which recently doubled its dividend and pledged to buy back almost \$19 billion of stock. It has been a long road for the financial institution following the Great Recession. However, since then, its repaired balance sheet has enabled renewed profitability and capital strength, restoring investor faith in the business. We continue to believe the stock is undervalued and should trade closer to its peers now that it has exited more risky businesses and passed rigorous Federal Reserve stress tests with flying colors. Reaching peer valuations could mean another 40-60% upside from Citigroup's current level.

Another contributor in the quarter was **Crown Castle International**, an investment we made in the first quarter. The company has been a direct beneficiary of what we like to call the "data revolution." As the proliferation of cell phones and media escalates, consumers are demanding both more and faster data. Crown Castle buys land, builds cell towers and leases slots to various cellular telephone providers. We believe that tower companies will continue to grow their profitability with the growth in data demand. In turn, this should fuel cash-flow and increases in its 4% yield. Coincidentally, one of the largest drags on the portfolio in the quarter was one of Crown Castle's sources of revenue, **Verizon Communications**. Shares of Verizon were down in the quarter as competition heated up among peers. We expect these pricing pressures to normalize over the longer term, and while they do we will collect an almost 5.5% yield. These two investments are illustrative of the balance in the portfolio as we aim to diversify risk while generating income.

The go-go market has created opportunities in less cyclical businesses as investors chase growth. One such investment is **Amgen**, 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



Grisanti Capital Management

these new opportunities to come to market, we collect a growing dividend of almost 3%, protected by a solid balance sheet.

Another investment we made in the quarter was **Walmart**, which sports an almost 3% yield. Although we like Walmart for its strong balance sheet, stable sales, and ability to generate strong cash flow in times of economic downturns, we are also attracted for another reason: its rapidly growing e-commerce business. The company has been focused on expanding this initiative after it acquired Jet.com last August. It has been a challenge for the company, as it balances investing in its legacy stores and growing its internet presence. However, investments over the last few years are beginning to bear fruit as the company has been able to return to earnings growth after multi-year stagnation. We believe that its e-commerce segment will continue to grow by successfully leveraging its existing customer and store base. In turn, the company can continue producing both strong cash flow and increasing returns to shareholders.

Although technology did get expensive in the quarter, there were opportunities that presented themselves, including **Oracle**. The company's wide range of database software makes its customers' business processes more efficient. This gives it an important edge in a world increasingly focused on competitive advantages created by technology. As a result, Oracle's corporate clients tend to be very loyal. Although earnings momentum had stalled in the past few years, increasing cloud adoption among its customer base is once again driving growth. We believe this company fits well on the appreciation side of the portfolio. The company sports a smaller dividend (1.5%) but strong growth in free cash flow. This cash flow should aid in boosting both share price and returns to shareholders.

Despite overall market conditions, we continue to focus on preservation of your capital. We find it increasingly important to invest in companies that not only have the ability to return cash to shareholders now, but also when economic prospects are not so bright. The average post-war expansion is only 59 months (about 5 years), and the longest was 120 months (ten years). We have entered the ninth year of an economic expansion and although we don't anticipate a slowdown in the near future, we believe it is prudent that your portfolio be prepared for a rainy day, ever as the sun still shines.

Very truly yours,

Christopher C. Grisanti