



Grisanti Capital Management

October 11, 2017

Dear Clients & Friends of Grisanti Capital Management:

How would you answer the following hypothetical question? If, in a three month period, the party that controls both Congress and the White House promises pro-growth legislation but fails after numerous attempts to pass any, *and* there were two massive hurricanes that hit two of the country's most populous states, *and* we were on the brink of a possible nuclear war with North Korea, just what would the stock market do? If you guessed it would continue its steady upward trajectory and rise 4.5%, you'd be correct.

As you can probably tell by the tone of that question, we believe investors are not being as cautious as they ought to be. And cautious management, for better or worse, is what we delivered in the third quarter. Your large cap value portfolio was up in the third quarter by about 2%. Our analytical team works all day because they think our goal is to identify undervalued companies, but that's not quite accurate. Our *true* goal is to make you a considerable amount of money over time. The best way to do *that*, in our twenty-plus years of experience, 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.

The most important thing to keep in mind right now is that, from an investment standpoint, these are not normal times. 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 steady upward movement of the current market. It's weird, and it's risky.



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We feel so strongly about this, that I offer the following visceral metaphor: Think of the investment world as hundreds of investors living in a cave. Our food source is outside of the cave. The problem is, there are wild animals outside the cave that will eat us if we are not careful. So, when we venture out, we take precautions. We go at night; we take fire sticks and spears; we train to defend ourselves in case of trouble. Because of these precautions, we eat well most of the time. But now, for whatever reason, those predators don't seem to be near the cave. We don't know where they are, or how long they will be gone. Some of our fellow cavemen are overjoyed. They venture out often, even in the daylight. Some are even getting fat. We, on the other hand, continue taking the usual precautions, and they are starting to make fun of us. We are not eating as well as they are, but we're not starving either. We remain afraid of being eaten alive. You get the point. Now a report on your portfolio from inside the cave:

Our third quarter was aided by three technology stocks that sell below the market's P/E multiple: **Apple**, **Skyworks** and **Qorvo**. Unless you actually live in a cave, you've heard of that first one. The other two are semiconductor chip makers that manufacture various parts of the iPhone. All three rose in anticipation of Apple's biggest new product announcement in years, the iPhone X (pronounced "iPhone Ten"). That announcement came in mid-September, but the phone itself won't be available until early November. Expectations are high (which we don't like), but we think they will be exceeded, as many consumers have deferred ordering new phones for quite a while in anticipation. Also, we really like the new watch, which can receive phone calls for the first time without your phone also being nearby. We think that will be a "sleeper" success for Apple. Apple and Skyworks have already been our best investments this year, rising 32% and 37% respectively. (Qorvo is a relatively new investment, and was up 12% in the third quarter.)

Another winner 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 is facing a lot of competition and sales are falling. We believe this bad news is already reflected in the low share price (down 47% from its high of two years ago), and the company has smart management and (we never tire of mentioning) has lots of cash. 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. It's a drastic therapy, but it has miraculous cure rates in cases that were almost certainly terminal. The stock rose 15% in the quarter, but still remains cheap at 9 times earnings.

Other healthcare investments were not as helpful in the third quarter. **Allergan** dropped 15% in the quarter, continuing its up and down movement since purchase (in the first half of the year, Allergan was up 16%). Investors are worried about the growth of its dry-eye drug Restasis. At less than 12 times next year's earnings, we think such worries are already reflected in the share price. Generic drug maker **Mylan** also declined 14% in the quarter on lackluster earnings. We added more to that investment, as we believe that investors were focused on short term

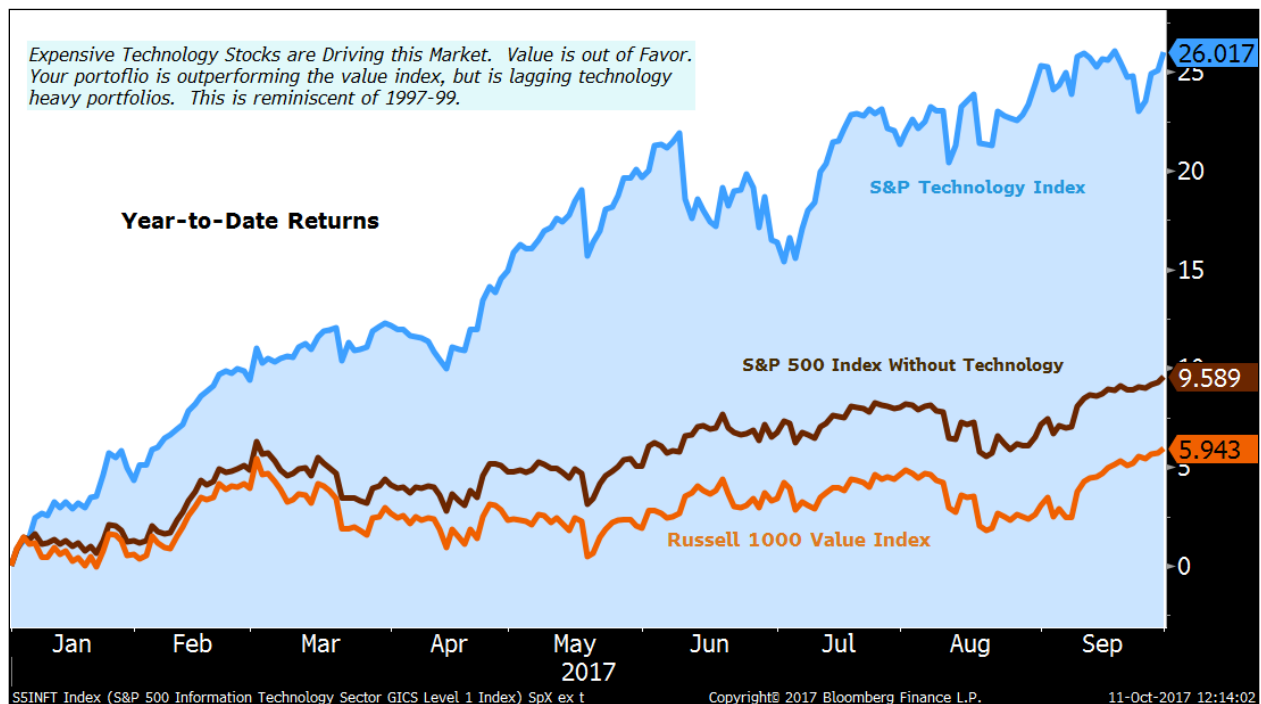


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results, while ahead lay possible new drug approvals and more positive sentiment. We received good news in the first week of this new quarter – Mylan obtained FDA approval for generic Copaxone, an MS drug, and the shares rose 21% in a week, giving the entire portfolio a strong start to the quarter. Like Gilead and Allergan, it is Mylan’s low valuation (at 6.5 times earnings) as much as its potential future that excites us. In short, we look for both good companies *and* good entry prices.

Our need for *both* those features to be present resulted in our recent sale of **Mastercard**. This was a tough sale for us, as it is a good company, but it is no longer at a good price. It is up 25% this year, and 90% (including dividends) since we purchased it in October 2014. When we bought it, it was selling at 23 times earnings. When we sold it, it was selling at 33 times. (In fact, it now may be the most expensive financial company in the United States.) In comparison, the relatively expensive market is now selling at 19 times earnings; Mastercard is 73% more highly priced than that. In the interest of full disclosure, Mastercard continued to rise after we sold it. Still, we have no regrets. Over the years, you can make a lot of money selling too early. At this price, there is too much risk in Mastercard for not enough future reward.

It is admittedly frustrating when our value style lags behind a technology-driven market. It reminds us very much of the late 1990s, when internet stocks dominated market averages. While our portfolios appreciated well during that period, we did not keep up with the high-growth/high-risk market. But in subsequent years, we continued to appreciate as the market declined sharply in 2000 and 2001. This chart shows the extent to which technology is driving this market, and it also shows how value is lagging.





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Right now, many of our inexpensive companies remain unloved. Our value portfolio trades at an average of 15 times earnings, a 20% discount to the market. Meanwhile, companies that we view as already expensive rise even further. We will continue to do our homework, and we won't chase expensive investments. We have been doing this long enough to know that this strategy works well over time. 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 (some of which we presented in the first paragraph of this letter), we think precautions are warranted.

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

Very truly yours,

Christopher C. Grisanti