Grisanti Capital Management

January 18, 2018

Dear Clients & Friends of Grisanti Capital Management:

History doesn't repeat itself, but it often rhymes.

– Mark Twain (attributed)

Your investments continued to appreciate in the fourth quarter, with our average large cap value portfolio up about 3.5%.[1] While the year's appreciation was meaningful, it lagged a market driven by growth stocks, mainly in technology. In fact, in 2017 the S&P 500 Technology Index was up 37%, while the S&P Value Index was up less than 11%. We have not witnessed this type of bifurcation for 20 years. Much of this letter discusses historical comparisons to the late 1990s, the last time this "tale of two markets" phenomenon played itself out. Not coincidentally, it was also a time when our portfolios at first underperformed a growth-driven market, only to greatly outperform in the ensuing years as the economy slowed and growth stocks with high valuations declined sharply.

Before looking back, let's review the current portfolio, which is off to a strong start so far in 2018 (up over 5%, about 1% ahead of the S&P 500 Index). In spite of our valuation concerns, we believe there is momentum behind the current market and the path of least resistance remains upward. We remain fully invested in high quality investments. While such exposure gives us some pause in an expensive market, we take comfort, ironically, from the strong-growth-stocks/weak-value-stocks bifurcation mentioned above. The same feature that has limited the appreciation of our value portfolios in the short term also allows us to remain fully invested in an expensive *overall* market, because we can find pockets of value that have been left behind. Again, this is reminiscent of 1999.

Of course, we remain fully invested in a *value* style. We own some technology stocks (**Apple** was our best performer last year, up 48%), but they are less expensive than the market (with the exception of **Facebook**). We own **DXC Technology**, which is currently our favorite technology idea, and trades at only 11 times earnings when factoring in the new tax law. That's 40% less than the market multiple and 60% less than the current technology index valuation. We

[1] The performance noted is for the GCM Large Cap Value Composite. Due to tax considerations or other factors such as cash position or deposits and withdrawals, the performance of your actual portfolio may vary, and is included with this letter. Past performance is no guarantee of future results. As with any investment vehicle there is always the potential for gains as well as the possibility of losses.

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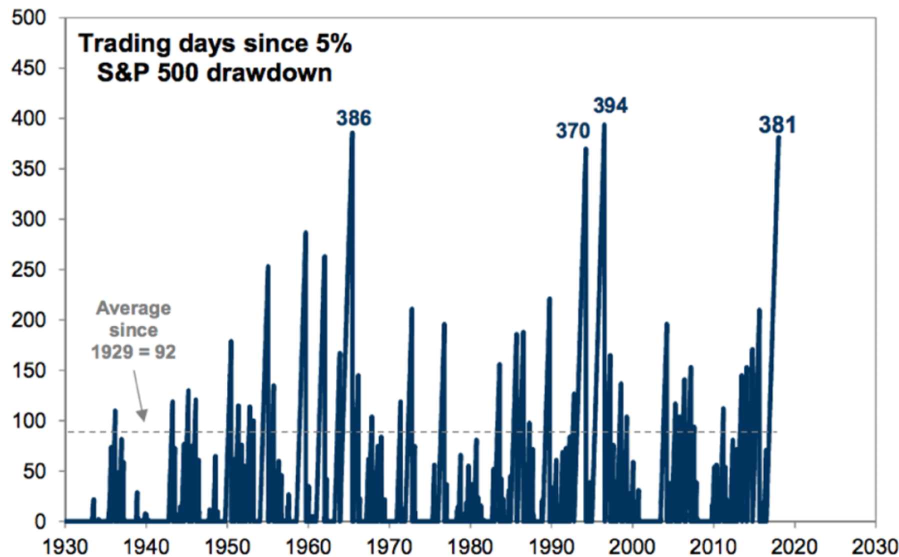
like the *attributes* of technology – who wouldn't want growth, innovation, etc.? – but everything has a price, and technology is getting increasingly expensive. We are finding most of the attractive value in other areas, especially finance (**Wells Fargo**), consumer stocks (**Lowes** and **Disney**), and healthcare (**Mylan** and **LabCorp**). These stocks have been leading the way so far in 2018, as technology has started to lag. Whether this new trend will continue or not is unknowable, but either way we are confident we own reasonably priced businesses that can perform well even if (or *especially* if) the market gets choppy.

Looking Back to Look Forward: 1997 - 2004

In Sir Conan Doyle's *The Adventure of Silver Blaze*, Sherlock Holmes solves a murder by paying attention to the dog that *didn't* bark. (Spoiler alert – The hound's silence that night indicated that the murderer was no stranger.) Sometimes things that *don't* happen have great significance, which brings us to the equity market in 2017. Last year's market was an aberration, because it suffered *no significant setbacks the entire year*. The chart below shows that 381 trading days have 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). The lack of a market decline is the dog that didn't bark, and it concerns us.

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



Source: Goldman Sachs Global Investment Research.

As it is, there have only been four such long streaks since the 1920s. Significantly, the most recent two occurred in the late 1990s. The current market echoes that era to an extraordinary degree: Value investing greatly underperformed growth investing. There was evidence of bubbles in both cases. In the late 90s, internet stocks without earnings went up ten-fold or more.

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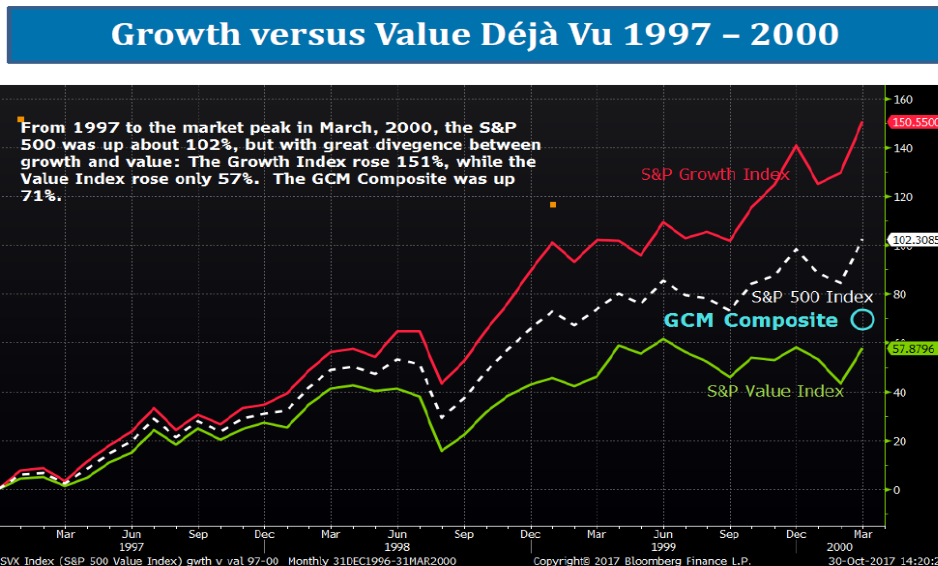
In 2017, there were excess too – Exhibit A might be Bitcoin, up 1,556%, or 15-fold in 2017 alone:

In the three years from 1997 to 1999, the market rose to ever greater heights (again, without a 5% decline), but then the party ended, and much (but not all) of the market fell to earth over the following three years (2000 – 2002). Investors who were lulled into complacency by a market that never went down paid a heavy price.

This is where your portfolio comes in. We are managing your money for the long term, and while you will earn a good return in these aberrant go-go years, we will not keep up with a market driven by speculative, growth-oriented names. Where we have added real value in the past is on the 'return trip.'

In the period from 1997 to the market peak in March of 2000 we lagged the market by over 30%,[2] though we offered decent absolute returns (up 71% in the three-plus year period).



[2] Performance shown for the period from January 1, 1997 through December 31, 1999 includes performance from a prior firm. During this period, the same portfolio manager advised accounts (which later became GCM accounts) using substantially similar investment policies and strategies as then used by Grisanti Capital Management LLC.

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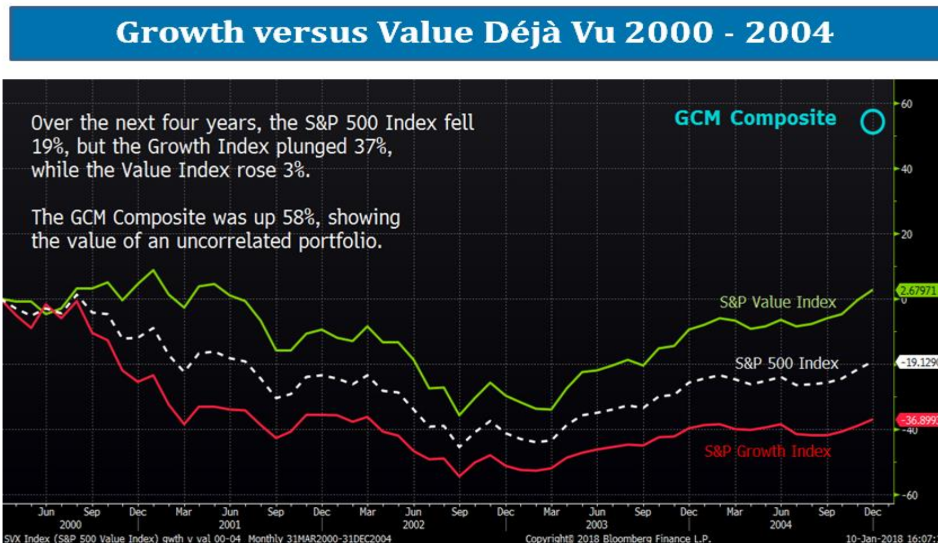
Then, from March 2000 until the end of 2004, the market dropped, but we continued to rise. The market was down 19% for that period, while we rose 58%, more than making back our lagging performance and protecting capital.



The reason we outperformed was, of course, the investments we made. But, to bring us full circle to Holmes and his silent dog, it was also what we *didn't* own. By the time of the market peak, we owned no technology at all, and were otherwise void of more speculative stocks. When those high-flyers finally came down, they brought much of the high-priced market with them, but once this obsession with technology and growth was broken, investors sought reasonably priced investments and returned to value stocks.

In 1999, it looked as if value was never going to be ascendant again, and that growth investing had at last answered the age-old question – what is the most profitable way to invest? Yet, just a few years later, growth investors not only underperformed, but actually lost a lot of capital -- something that did not happen to value investors, as they underperformed on the way up by simply making less money.

So, have we come full circle? Mark Twain said that history doesn't repeat itself, but it often rhymes. There are differences with 1999. First, current valuations, while high, are not at the record levels they reached at the 1999 peak. Also, today's market leaders are *profitable* technology darlings (Netflix, Amazon, Google, etc.), which are different than the internet stocks of the 1990s, many of which had little revenue and no profits. But such arguments merely beg the question: even with their profits, these market leaders have to be valued at *some* finite number. What is *too much* to pay for them? And what happens when interest rates rise, or when the economy slows, or, more likely, when the world changes in ways we cannot predict as we sit here enjoying the market- equivalent of a cloudless day?

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The bad news is that we have no answer to these questions other than good long term investing requires a margin for error. But the good news is that answer has provided us with superior returns over an almost 20 year period. As valuations rise, that margin for error shrinks. Our historical look back is intended to deliver the message 'we've been here before.' No one likes to underperform, but in our experience what investors *really* don't like is losing money. The lack of volatility and the continued updraft of the current market is not normal, and the best thing we can do for you is keep that in mind. Your portfolio remains structured for long term performance in an uncertain world.

Very truly yours,

Christopher C. Grisanti