Grisanti Capital Management

April 18, 2018

Dear Clients & Friends of Grisanti Capital Management:

What a difference a quarter makes. In our last letter, we wrote that 2017 was a bizarrely calm year, with the least market fluctuations since 1963. While everyone enjoys making money, we warned that such steady upward movement can lull investors into a false sense of security. It produces too much greed and too little fear, lifting the share prices of both good and bad companies and leaving few attractive investment opportunities. It was, we believed, unsustainable. Well, as the old saying goes, be careful what you wish for. The first quarter of 2018 brought the return of volatility, with the market down for the first time in 10 quarters. We used the sharp market movements to make some promising investments.

We don't want to overly dramatize the current market action, which so far seems like a garden variety correction that seems more alarming contrasted against last year's calm. The High Income Equity Portfolio was down 4.0%,[1] slightly ahead of the S&P Value Index (down 4.2%). For a portfolio that is supposed to protect capital, that was disappointing, but we navigated the choppier seas better than the short-term performance might suggest. The large position in floating rate preferred stocks helped considerably during market declines. On days when the S&P 500 Index dropped by more than 1% – and there were 11 such days in the first quarter, more than in *all* of 2017 – the HIEP portfolio was down about half as much.

The reason the HIEP declined 4% in the quarter was not the volatility, which we navigated well, but two other factors. First, almost half of our losses for the quarter came from three companies – **Comcast**, **Walmart** and **Wells Fargo**. Each is a long-term investment that remains profitable after its decline. In fact, we think the negative price action has presented a good opportunity for future appreciation, and we have added to two of these positions (Comcast and Wells Fargo), as business and profits remained solid and those shares reached their lowest valuation in five years in an otherwise expensive market. A summary of the investment merits of both of these companies can be found in the memorandum accompanying this letter.

The second reason for the HIEP's decline was that all value managers continued to suffer from the continued outperformance of expensive technology stocks. Once again, technology separated from the overall market. The S&P Technology Index was up 2% for the quarter, while the rest of the market (the S&P 500 Index *excluding* technology) was down over 3%.

While technology stocks surged in January, since March 12, the sector is down 7%, almost twice as much as the non-tech market. After the quarter ended, the sell-off also created an opportunity to initiate a position in **Facebook**, a particularly beaten down technology

[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.

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company. Although the company doesn't pay a dividend, we believe the valuation (just 16 times next year's earnings) provides the opportunity for meaningful capital appreciation. We have also included a more in-depth description of this investment in the attached memorandum.

Another stock which detracted from performance in the first quarter was **Walmart**. We've owned the company for a little less than a year, and it contributed meaningfully to the portfolio in 2017 (up nearly 30%). Although the stock was down 9% in the first quarter, we believe the future remains bright. Walmart is one of the few companies that is well positioned to compete with Amazon, given their low prices and robust store base. Investments in its own online business are also resulting in strong growth, up over 40% in 2017. As you know, our HIEP portfolio is constructed as a barbell, designed to combine both safety and income on one hand and capital appreciation on the other. We believe Walmart fits well on both sides of the barbell – a stable business at an attractive valuation with both income (2.5% yield) and the chance for meaningful capital appreciation.

The return of volatility doesn't necessarily mean lower stock prices in the long run. The economic backdrop remains solid, with unemployment low and economic activity both healthy and increasing in almost all the industrialized world. Rising interest rates continue to be public enemy number one, and as they inch higher, the market will shudder. But they remain historically low, and provided they don't rise a lot – an important caveat – we think the market will get used to, say, a 3.25% or 3.5% yield on the 10 year Treasury Bond if economic activity remains robust. (After all, the average yield on the 10-year Treasury Bond since 1960 is 6.2%.)

The new and often volatile policies of the current administration make it harder to forecast the economic landscape ahead. Will there be a trade war? A real war? A war just on Amazon? What will the deficit look like (which can have a material effect on interest rates)? Yet, the new tax law remains a tailwind to earnings this year, and has made an expensive market a bit less so by increasing the earnings of domestic companies. New portfolio investments like **Home Depot** will see their profits rise more than 10% this year simply because they will pay less in taxes. While there are certainly more cross-currents than normal right now, they are not all bad.

We work to find investments in companies that combine good management, strong businesses and, crucially, an attractive entry price. In a runaway market like 2017, there are terrific companies that combine the first two characteristics, but lack the third. For example, Netflix, Tesla and Amazon are groundbreaking firms with exceptional management, but they now trade at over 100 times earnings, more than *six* times the valuation of the average company, which itself is selling above the post-war mean.

We believe there is an important point to be made here: A market price of *100-times earnings* for big companies is not just expensive, it is also extremely unusual. We've only seen such valuations on a large scale once before, in the internet boom of the late 1990s. Amazon, Netflix and Tesla didn't achieve their lofty 100-times-earnings status because they are uniquely fantastic – there are great companies to be found in any era – but because of the *moment* we find ourselves in. Right now, investors are focusing on all of the *opportunity* available in these

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companies and none of the *risk*. As long as this moment persists – and such a "moment" can last months or years – those stocks will continue to get even more expensive, and by not owning them, we could underperform. But risks inevitably arrive, and they often come from unpredictable directions: A Presidential tweet, a trade war, a competitor's new invention, or simply the world waking up one morning and saying 'that's too expensive.'

So, instead, we want to find companies that are well led, have enviable market positions *and* come with a reasonable price tag. **The three companies in the accompanying memo fit that description well.** Each sells at less than 17 times earnings (which, after doing the difficult math, turns out to be considerably less than 100). We will revisit these investments in upcoming quarters so you can hold us accountable. We also invest our own money in these same investments -- we eat our own cooking (and we haven't starved yet). Over the almost 20 years since we started the firm, I remain convinced the only way to increase wealth is to invest over long periods in solid companies at good prices. Right now, we believe two things are changing: Volatility is returning, and technology seems to be losing its market momentum. Many investors are upset about this, but both these changes play to our strengths and we are upbeat about the opportunities ahead.

Very truly yours,

Christopher C. Grisanti