Grisanti Capital Management

April 4, 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, and more 1% moves (up and down) than we saw in *all* of last year. 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 GCM Composite was down about 3.4%,[1] but we navigated the choppier seas better than the quarterly performance metrics might suggest. Once again, technology separated from the overall market, with the S&P Technology Index ending up 2% for the quarter, while the rest of the market (the S&P 500 Index *excluding* technology) was down over 3%. Our benchmark, the Russell Value Index, declined over 3% as well. There are two reasons we are more optimistic about future performance than one might conclude from the quarterly numbers alone.

First, technology was fading fast at the end of the quarter, and on days when technology weakened, we outperformed. While technology stocks surged in January, since March 12, the sector is down 7%, almost twice as much as the non-tech market. And so far in the second quarter, technology continues to underperform.

[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.

Grisanti Capital Management

The second reason for our relative optimism is that more than half our losses for the quarter came from three stocks we've owned for a long time and we view their decline as temporary. In fact, we think the price action has presented a good opportunity for future appreciation, and we have added to our positions. While the three companies – **Comcast, Wells Fargo** and **Facebook** – fell about 20% from their highs, business and profits remained solid, with the declines stemming from non-earnings-related news. A summary of the investment merits of each of these companies can be found in the memorandum accompanying this letter.

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 **Union Pacific** and **Dollar General** 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.

As you know, we work to concentrate our investments in relatively few 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 extremely unusual. We've only seen it 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 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. 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.'

Grisanti Capital Management

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