Grisanti Capital Management

October 10, 2018

Dear Clients & Friends of Grisanti Capital Management:

The lark's on the wing;
The snail's on the thorn:
God's in His heaven—
All's right with the world!

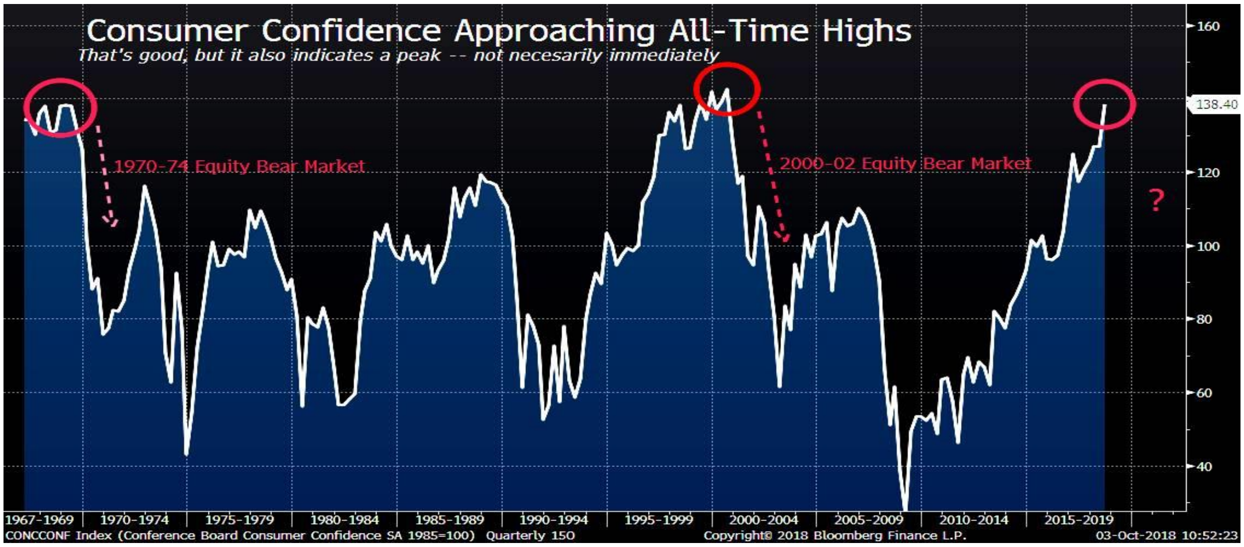
– Robert Browning, 1841

Investors basked in good economic news in the third quarter, as the market was propelled by strong earnings and consumer optimism. Your High Income Equity Portfolio (HIEP) rose nearly 4%.[1] Corporate taxes have been cut, giving many firms a (one-time) surge in earnings. Not to be outdone, agencies have cut regulations even more than taxes. Meanwhile, the unemployment rate hit its lowest level since 1969. Consumer confidence is approaching all-time highs. While interest rates are rising, they remain well below historical norms. Reflecting all this good news, the market has made numerous new highs. To borrow from Robert Browning, for investors at least, 'All's right with the world!'

Such euphoria makes us believe it's a good time to be cautious and adhere to our HIEP investment goals: preserving capital and providing income while seeking reasonable investment opportunities that allow for capital appreciation. So far, in this volatile fourth quarter, we've been rewarded for our conservative strategy. The S&P 500 is down 4.35%, while the HIEP is down 1.84%.

We are a data driven firm, and a look at historical metrics will help explain our concern. Investing is less about assessing the current situation and more about anticipating what happens next. The chart on the following page reflects what has happened in the past after the economy experiences such benign conditions as we find ourselves in today. It looks at consumer confidence for the past 50 years (but we could have picked unemployment rates to make the same point). There were only two periods (late 1960s and late 1990s) when consumers were as confident as they are now. This positivity can last for some time, but is likely to end with increased market volatility.

[1]The performance shown is for the GCM High Income Equity composite.



While we want to sound a note of caution, we are not all doom and gloom. The U.S. economy is an ocean liner, not a speedboat, and it has strong momentum. We are not expecting an imminent decline, and we continue to find attractive investments, which we will outline further below. But, each up-cycle sows the seeds of its own demise. Companies (and consumers) become optimistic; business is good; they borrow money; because of low default rates, lending standards are relaxed. Then, interest rates go up, and stress is added to the system. Finally, in the natural order of things, the weak links break first, and the system slumps.

As we've discussed in previous letters, we believe our barbell strategy – balancing safety and income with capital appreciation – positions the portfolio well to participate in strong economic times such as these, while also defending against an eventual cool-down. We pursue a margin of safety in all our investment decisions, preferring to not chase stocks in a hot market that we consider risky. While this may hamper short term performance, we strongly believe that capital preservation is the pre-requisite for growing that capital over time. Buying good companies at discounted prices is the best way we know to achieve this goal over the long-term. We report on a few of these companies below.

We continue to hold almost 30% of the portfolio in preferred stocks or non-common-equity securities that significantly reduce the portfolio's volatility. A crucial part of the safety and income side of the barbell, these securities are mostly *floating rate preferred stocks*, with high dividends, issued mostly by investment grade companies (like JP Morgan and Goldman Sachs). This part of the portfolio is yielding approximately 5.8%. We continue to believe that in a rising rate environment opting for *floating* rate preferreds (as opposed to fixed rate), insulates these securities from price declines as their dividend *increases* with rising rates. In equity drawdowns and sharp interest rate moves, these securities have historically held their value as investors are attracted by their relative safety and flexible coupons. From the end of August to early October, the United States 10 year-rate moved sharply up from 2.8% to 3.25%. Our floating rate securities were unchanged, well ahead of investment grade bonds which were down around 2%.

Apple was the best stock of the quarter, up 22%. Continued earnings strength along with an exciting new iPhone XS Max pushed Apple over the $1 trillion market capitalization mark, the first U.S. company in history to do so. (These are just the sort of things that happen in a bull market.) Apple was an example of a company that we bought in late 2016 at less than 12 times earnings. The iPhone X was a year away, and analysts were saying that everyone already had a cell phone and didn't need a new one, especially one that cost over $1,000. We guessed the phone would be a hit, and we were right, but just as important as being right is that we didn't pay a lot for the stock. That is important for two reasons: Because we were right and the stock was cheap, it went up a lot more than it would have if we had bought it at a more expensive valuation. But more importantly for protecting your capital, if we happened to be *wrong* instead of right, we wouldn't have lost as much money as the stock had already fallen from grace prior to our purchase.

Another example that we have written about before is **Comcast.** The nation's largest cable company and also the owner of NBC/Universal, it has arguably the second best set of media assets in the United States (with Disney in the number one position). The stock was punished in February when the company made a bid for Fox. When shares fell about 30%, we added to our position in March. The stock was up 8.5% for the quarter and we continue to believe in Comcast's management and its history of money-making acquisitions, including NBC/Universal. Several weeks ago, in a complicated ending, Disney won the bidding war for Fox, and Comcast will buy Sky, the European cable company, from both Disney and Fox. The market reacted poorly to the finalization of the acquisition, though this was the ending we were hoping for. Although the stock dropped 7% that day, shares acted similarly when Comcast bought NBC. It was a terrific acquisition and paved the way for superior growth over the next decade. We think the Sky deal is another winner, and we're happy to be partners with this management team. In addition to being a candidate for meaningful capital appreciation, the company also has a 2.2% yield and has grown that payout by 20% over the last year.

We also want to focus on a new investment in **Schlumberger**, a company that locates reserves, provide tools and helps oil companies drill for oil. The reasoning is straightforward. Not surprisingly, like the shares of oil companies themselves (e.g., Exxon), share prices of oil service companies are positively correlated with the price of oil. As you probably remember, oil plummeted from $109 a barrel to $26 over an 18 month period ending in early 2016. At that time, shares of Schlumberger dropped almost 50%. Since then, oil has rebounded to $75. At the same time, Schlumberger's stock has done *nothing*, and you can still buy a share of SLB at $61. Why? We suspect that investors fear that oil companies, still smarting from oil's sharp decline, will be slow to hire Schlumberger to drill new holes. That's true (and always is after an oil slump), but there is only so long you can go without finding new oil to replace the depleted fields, especially when the economy is as good as it is now. The clock is ticking, and Schlumberger remains the premier company in the industry, with global scope and a double-A balance sheet. It yields over 3%, and it remained profitable even with oil at $26. This strikes us as a low-risk, high quality way to play a recovering oil market, with the potential to rise significantly over a three year period.

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We continue to act conservatively, investing in specific companies, which we believe will increase in value over a multi-year period, even in a more difficult market. There are potential road bumps ahead – midterm elections, the release of the independent counsel's report, and steadily rising rates among them. We can't promise when, but we can promise that there is a downturn somewhere ahead. Looking back at history, the likelihood is that things can't get too much better from here. Of course we should all enjoy the good times, but planning for more difficult times ahead seems prudent at this point.

Very truly yours,

Christopher C. Grisanti