Grisanti Capital Management

July 2, 2018

Dear Clients & Friends of Grisanti Capital Management:

And on the pedestal, these words appear:
My name is Ozymandias, King of Kings;
Look on my Works, ye Mighty, and despair!
Nothing beside [the pedestal] remains. Round the decay
Of that colossal Wreck, boundless and bare
The lone and level sands stretch far away."

– *Ozymandias*, Percy Bysshe Shelley (1818)

Shelley's Ozymandias was once an omnipotent ruler, admired by all. Now he is forgotten and nothing but rubble remains. We think his demise is a great metaphor for today's market dynamics, as a few investments seem unstoppable, while the rest languish.

We'll return to this important issue, but first, a more mundane review of the second quarter. In this frantic world, sometimes a boring three months is good. The second quarter was a decent if non-descript one, especially after the volatile start to 2018. The economy continues to show strength, even as interest rates rise. Political issues, especially trade, are dominating investor attention for the moment, but we think strong second quarter earnings should generate positive sentiment in the coming weeks.

Your portfolio did well against other value investors, rising about 1.4% for the quarter, slightly ahead of the Russell 1000 Value Index.[1] You may recall that we highlighted three stocks in our first quarter letter: **Facebook**, **Wells Fargo** and **Comcast**. Facebook led the portfolio with a 22% gain in the quarter. Wells was up 7%, and also beat the averages, while Comcast was flat (up slightly including dividends). We discuss the portfolio details further below.

[1] The performance shown is for the GCM Large Cap Value composite. Your actual performance is enclosed with this letter, and may be higher or lower.

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First, though, we want to return to *Ozymandias* (on its 200th anniversary) and talk about things that seem magnificent and indestructible, whether kings or transformative technology companies. This is important because while your portfolio fared well against its value benchmark, it continues to lag the S&P 500 Index. This is frustrating for client and portfolio manager alike, and it deserves a frank discussion.

If you think of the S&P 500 Index as "the market," then the market is becoming extremely narrow. This year only two stocks out of 500 accounted for more than half of the S&P 500's rise: Netflix and Amazon. We would posit that each is the Ozymandias of our era. Amazon and Netflix stand astride their world and other companies (and their investors) despair. But in their might, they have grown ever more expensive, as investors perceive their growth to be limitless. We think that's dangerous, and we'd like to share our reasoning: The overall market sells at an average Price/Earnings ratio of about 18 times (which itself is above the historical average). Your GCM Large Cap Value portfolio sells at about 15 times, or a 20% discount to the market. When we want to 'splurge' and buy an 'expensive' stock, we might pay 25 times earnings (as we have in the recent past for a fast-growing company like **Facebook** or **Google**). But Netflix and Amazon are in a league by themselves. They ended the quarter at a price/earnings ratio of 248 and 266, respectively.[2] That's 1300% more than the average large cap U.S. company. It's also more than 800% higher than either **Facebook** or **Google**, and 1500% more than **Apple**, all of which are sometimes lumped with Amazon and Netflix as "high-flyers." We own those other technology companies because their growth rates are worth the somewhat extra cost of owning them. We do not own Amazon or Netflix, because the extra cost is far greater and is simply too high. Yet the sky-high valuations of "Amaflix" didn't frighten investors this year, it attracted them. Netflix was up 104% in the first six months of 2018; Amazon was up 45%. That's where the market is getting its positive headlines from – without those two stocks, the S&P 500 Index would be up less than half as much.

Age does have certain advantages – we remember 18 years ago when AOL (America On-Line) was the Netflix of its time. AOL was the premier "dial-up" internet company at the start of the internet boom. Like Netflix, it became one of the largest corporations in the United States, and its stock rose ten-fold, even though it had hardly any profits. Its crowning moment came in 2000 when it bought an "old technology" company, Time Warner – that would be akin to Netflix buying Disney today. In 2000, AOL had a market capitalization of $222 billion. (Compare that to Netflix at $173 billion today.) And now AOL, surpassed by Netflix and broadband technology, is but a memory, as the lone and level sands stretch far away. Its stock declined more than 98% before the remnants were purchased by Verizon a couple of years ago. Here's a chart that shows the decline of AOL subscribers and the rise of Netflix. In corporate America –

[2] Bulls would argue that these two great companies are growing their earnings 30-50%, so that in several years the valuations will be much lower. We have two responses to that. First, that holds true only so long as those future earnings projections are correct. But we are in the tenth year of an economic expansion, longer than any on record, and we are due for a slowdown eventually. Projecting strong growth through 2022 seems a stretch, and even mighty Amazon may experience a slowdown in a recession. Second, either the stocks 'grow into' a more normal valuation by remaining essentially flat as their earnings grow, or they continue to appreciate as they have this year and remain super-expensive. In the former case you are not paid for your investment; in the latter, you continue to take on exorbitant risk, as there has never been a company of Netflix's size that could continue to grow as fast as its current valuations would demand in order to reach a reasonable valuation without a sharp decline in price.

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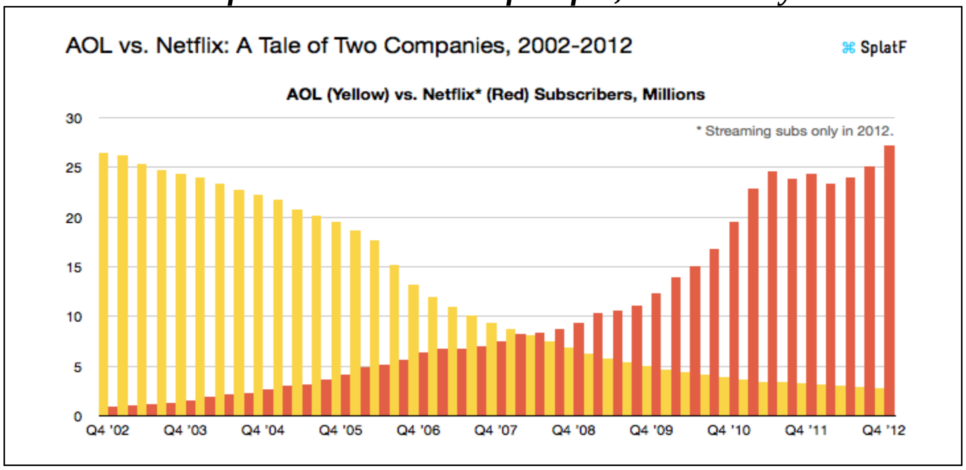
and especially in the technology sector – nothing lasts forever. In fact, AOL's dominance lasted less than a decade.

The Decline of AOL and the Rise of Netflix, the next Ozymandias?



If history is any guide, this narrow market is unsustainable. But there is a silver lining: a narrowing market is good in the long run for value investors. The more companies that get left behind, the more high-quality, money-making firms we have to choose from. Although it's rare, we are happy when we identify a reasonably-priced investment in the high-growth technology sector. **Facebook**, an investment discussed at length in last quarter's letter, was one such company, as we used its recent decline to establish a large position at an attractive price (by some measures, at the cheapest valuation since becoming a public company). Facebook was our best investment for the quarter, rising 22% for the quarter and almost 30% from the price at which we purchased additional stock in April. We continue to believe that the issues involving the security of its users' personal information will be solved. In fact, most of the negative headlines involve data breaches that occurred years ago. If the company can secure its data – and it has every incentive to do so – it will retain the goose that lays the golden eggs. We believe management understands this and will act in its own best interest. So far, so good, though these crisis-driven stories can be volatile.

The portfolio's largest position, **Wells Fargo**, also performed well in the second quarter, rising 7%, even as the S&P Financial Index fell by 4%. We continue to think that three factors forecast more gains ahead: (1) investors are pessimistic about the company, driving the valuation down; (2) tax reform means Wells Fargo will earn 15% more this year than analysts had estimated and (3) the Federal Reserve's recent stress tests found Wells Fargo to be the most over-capitalized of any major bank. This last factor, announced in the final week of the quarter, permitted the company to raise its dividend by 12%, and announce a $24 billion share buy-back.

While a narrow market is one sign of a top, I do not mean to imply that we are precisely there yet. No one knows when the peak will come – and perhaps it has already passed, as stocks set their high in late January so far this year. All we can do is prudently invest your capital in undervalued companies. Whether it's Facebook, Comcast or Wells Fargo – or new investments

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like oil service providers and medical lab testing firms – we believe these individual companies can increase profits and demand a higher price from investors several years from now. That's because they are high quality, well managed companies. But it's also because we are not paying an exorbitant price for them to begin with. In these frothy times, it's important to remember the old adage that there's no investment so attractive that it can't be ruined by a high enough entry price.

We look forward to reporting back to you at the end of the third quarter.

Sincerely yours,

Christopher C. Grisanti