



Grisanti Capital Management

January 14, 2020

High Income Equity Portfolio Fourth Quarter 2019 Letter to Investors

For the Period Ending December 31, 2019

	Year To Date	Current Yield	Current Beta
<i>GCM High Income Equity Portfolio</i> ¹	+26.5%	3.7%	0.6

Dear Clients & Friends of Grisanti Capital Management:

2019 was a strong year for the GCM High Income Equity Portfolio (HIEP), which was up 26.5%. Markets worldwide were positive, even in the face of trade friction, Brexit and impeachment. Your High Income Equity Portfolio is designed to provide safety and income along with capital appreciation. To achieve those goals, we combine equities with fixed-income securities. Both categories performed well in 2019, with your equities up more than 34%, and the fixed-income securities also appreciating over 14%. Just as important, since the inception of the HIEP (March 1, 2010), it has been 40% less volatile than the overall market.

It's satisfying to take a victory lap, but more important is what lies ahead. The end of 2018 was filled with opportunity, the faithful companion of fear. Now, attractive investments are harder to come by. The good news is that the reasons we were willing to deploy capital at the end of 2018 remain in place today. In fact, if anything, they are *more* prevalent now than a year ago. Employment remains strong. The Federal Reserve, which was raising rates a year ago, lowered them several times in 2019 and remains more dovish than a year ago. The trade war with China — the geopolitical event that seemed to harbor the most risk to equities — has cooled, with an initial deal set to be signed on January 15th. Inflation is dormant, allowing interest rates to remain historically low, with the 10-year bond below 2%. (A year ago it was 2.7%.)

¹ Performance for the High Income Equity Composite ("HIEP") does not reflect the deduction of investment advisory fees paid to GCM. GCM's advisory fees are described in Part II of its Form ADV. The HIEP Composite includes all accounts that are fully discretionary, managed in the HIEP strategy and over \$200,000 in total assets. 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. We use Beta, a widely recognized measure, to assess volatility. The Beta of the HIEP is 0.6, compared to the market's Beta of 1.0. All other things being equal, a portfolio with a Beta of 0.6 will fall (or rise) 40% less than the market. Of course, all other things are rarely equal and Beta is a measure of past volatility, which may or may not hold true in the future.



Grisanti Capital Management

So, even after a strong year, we remain optimistic and invested in high quality companies that can take advantage of the current environment. We don't expect stocks to be up another 30% this year, because valuations are not as attractive as they were after the plunge in late 2018. But, neither does the market scare us. Valuations are not in the historical "danger zone" and we have never found that valuations alone undermine the market. In short, we remain positive and believe with interest rates so low, equities are by far the most attractive investment category.

But being an optimist is not the same as betting on a sure thing. There are several ways we can envision a less attractive ending to our story. First, interest rates, after a ten year hiatus, could finally stop declining and start rising. Wages are edging higher, but so far have been more than offset by productivity gains. Should that balance shift, the Federal Reserve could start to raise rates again. That could create a déjà vu 2018-like equity swoon. Second, the presidential election will add volatility. If a progressive Democrat takes the lead and is perceived (rightly or wrongly) as anti-business, the market could suffer. Finally, trade tensions could re-emerge, though we think that is less likely in an election year. We highlight these issues as *short-term* risks. Every one of our investments was chosen for its long-term prospects, virtually all of which would survive these short term concerns. **Disney's** new streaming channel, for example, is a smashing success, and should deliver strong cash flow for years to come, even if interest rates rise or a trade war starts anew. **Boston Scientific** is hard at work developing new treatments for heart disease, not an insignificant problem in an aging world. We view ourselves (and therefore you) as long-term owners of these businesses. The risk seems less when viewed that way, and the opportunities greater.

As you recall, the HIEP is constructed as a barbell with two objectives. On one side, is safety and income; on the other, capital appreciation. Having spent time in recent letters detailing the safety and income side of our barbell strategy – which currently includes fixed-to-floating rate preferred securities and traditional high yielding preferred stocks– it is worth describing our strategy to provide capital appreciation. On this side of the portfolio, we search for companies whose businesses have strong defensive characteristics and predictable earnings. These companies should have high returns on capital and, more importantly, the ability to sustain those returns. When we find one of these good businesses, we wait for shares to become attractively valued to initiate a position. Often (but not always), these companies pay a dividend, augmenting our income objective as well. Our focus on good businesses and waiting to buy until they are trading at a discount to intrinsic value paid off in 2019. The common equity side of the portfolio was up over 34%, ahead of the S&P Index, even though our focus is on more stable companies that might not fare as well in a soaring market. It's worth noting that the fixed income side delivered a total return of over 14%, which was also stronger than fixed income indices such as the Barclays Aggregate Bond Index in 2019 (which was up 8.7%).



Grisanti Capital Management

In the remainder of the letter, we review a few of the common stocks that contributed to our strong performance in 2019, one of our mistakes and a new investment.

The streaming gateway **Roku** was our best performing investment in 2019, up 108% since its initial purchase in April 2019. Because of its volatility, we kept the position small, but because its rise was so large, it was a material contributor to 2019's results. Although Roku shares have enjoyed a stellar run, we think the shares continue to represent an attractive opportunity. In its latest quarterly earnings report, Roku's operating results demonstrated its lead in streaming, with an installed base of 32.3 million unique U.S. households, who watched 10.3 billion (yes, *billion*) hours of streamed content in the quarter. Its continued success is due to its powerful value proposition to consumers, content providers and advertisers. First, and we think most importantly, consumers want optionality and simplicity when they enter the world of streaming. Roku's interface provides a sleek and easy way to stream many different channels. Second, content providers like Disney and Netflix want a pipeline that not only offers them a large group of customers but also handles the delivery of their new streaming channels. As its installed base grows, Roku's importance to content providers becomes increasingly attractive, and its size becomes a barrier to other entrants. Lastly, with traditional cable viewing in secular decline, advertisers need a way to reach streaming customers, some of whom have never had cable TV. Streaming advertisers need a platform that can target potential customers in the same manner as Facebook and Google. Streaming is a whole new industry, and we think Roku is in the proverbial right place at the right time.

Facebook, a relatively new HIEP investment, is attractively valued at only a 10% premium to the market valuation (on 2020 P/E), even though it is growing both sales and profits three times faster than the average market company. This is a great example of what we consider value investing – buying terrific assets not at a dirt cheap price, but at a low price compared to what they should be worth. Most of Facebook's revenue comes from advertising on the Facebook platform, but it also has created (or acquired) Instagram, Messenger and WhatsApp, all three of which are in the top ten social media platforms worldwide. As opposed to most of our other investments, our biggest concern here is non-economic. Antitrust and privacy regulators have opened an investigation into Facebook. This investment reminds us of our investment in Microsoft in the 1990s. Both have great growth and high profitability. When the government announced an antitrust investigation of Microsoft in the late 1990s the stock suffered in the short term, but was a stellar investment over time as profits continued to grow. Of course, the government lost its quest to break up Microsoft. Similarly, we think it unlikely that the government will break up Facebook, but if it does, the parts of Facebook (e.g., the Facebook platform, Instagram, WhatsApp, Messenger, etc.) will be worth *a lot* of money.

The mistakes of 2019 were more lost opportunities than lost capital. The best example is **Wells Fargo**, which was a mediocre investment (but still money-making) for three years before we sold it in 2019. We have increased our research focus to try to eliminate companies that are “value traps” — companies that are cheap, but stay cheap — so that we can repurpose limited investment dollars towards more productive opportunities.



Grisanti Capital Management

Research, after all, is what our business is built upon. On that score, I am pleased to report that we have promoted Tom Marra, our talented Analyst, to be our new Director of Research. Tom has not only done great research on companies, but has developed into a thoughtful examiner of market trends and opportunities off the beaten track. Perhaps the best accolade I can give to Tom is that Roku was his idea. He brings a complementary, more technology-focused point of view to our investment meetings.

Again, we are pleased to have delivered a strong 2019, but like yesterday's newspaper (you remember, those things that used to get your hands dirty), you were glad to read it but are now using it to wrap fish. We have already turned our attention to 2020 and look forward to reporting back to you at the end of the first quarter.

We wish you a happy and prosperous new year.

Very truly yours,

Christopher C. Grisanti