Grisanti Capital Management

October 15, 2019

Dear Clients & Friends of Grisanti Capital Management:

The Optimist thinks we live in the best of all possible worlds;
The pessimist is afraid that's true.
– James Cabell

We are pleased to report that your High Income Equity Portfolio (HIEP) – which is designed for protection and income, and only secondarily for capital appreciation – was up almost twice as much as the market over the past 12 months.[1] And for the first nine months of this year the HIEP is up over 18%. These results were achieved with 40% less volatility[2] than the market and in the face of a 20% decline in the S&P during the 4th quarter of 2018. Although headlines remain unpredictable and almost relentlessly negative, we have a positive outlook in the near term. You may be asking: "Whatever for?" – and the fact that you might be put off by our outlook is a good, contrarian sign in itself.

Excessive pessimism is often fertile soil for strong future returns, and we perceive a lot of gloom among investors right now. One looks at the front page, and if the world isn't ending, it's at least peering over the edge. Stocks in the third quarter were buffeted by significant trade friction, political turmoil and a global economic slowdown. The coming presidential election may be between a controversial incumbent and a progressive who has been labeled anti-business. There seems to be no good news for investors. Oddly, we think it's a pretty good time to invest, and we'd like to explain why.

Our cautious optimism has three sources. First, a glance at the economic statistics shows things are not so bad on a macro level. In fact, in some spots they are positively frothy. Take unemployment: The latest unemployment rate (3.5%) is the lowest since 1969, the year Lyndon Johnson left office. At the same time, inflation remains dormant and interest rates are low enough to encourage home and auto purchases. That benign, almost unheard of combination of low rates and high employment is, to use a technical term, really wonderful. We admit things aren't perfect. Europe is slowing to stall speed, China is anemic as well, and even the U.S. factory orders have dropped to a seven-year low. Yet we also believe that the central banks in all

[1] Over the past 12 months, the portfolio is up 7.5%, versus the S&P 500 Index up 4.25%. The performance is for the High Income Equity Portfolio Composite, which is our model portfolio. Performance may differ due to factors such as a higher cash position, different investment objectives or non-discretionary securities held in your account.

[2] As measured by Beta, a commonly used statistic for measuring volatility compared to the market.

of those places, including our Federal Reserve, are moving quickly to lower rates and ease the money supply. China alone has initiated almost 100 easing moves over the last nine months. We think such worldwide, coordinated stimulus will start to show up in economic statistics shortly, and the markets will respond.

The second reason for our optimism is on a smaller scale but more relevant to your portfolio. Our portfolio companies are reporting that business is good and continuing to grow. The average earnings growth we expect this quarter is about 9.6% (compared to an economy that is growing at 2%). The HIEP continues to be focused on absolute return with less volatility and more income than the overall market. Our barbell strategy balances safety and income with capital appreciation. When valuations are attractive we can allocate capital to businesses that have the potential for material capital appreciation. Currently, we believe there is a powerful tailwind to the communications sector of the portfolio as these companies are on the forefront of the streaming revolution that we discussed in the last quarterly letter. **Facebook, Google** (now Alphabet), and **Roku** are growing revenues and operating earnings at double-digit rates. **Becton Dickinson** will sell enough syringes, catheters and other medical supplies to grow its revenue almost 10% this year. **Crown Castle** (an owner of cell towers) continues to benefit from continuing deployment of wireless capacity and coverage across the United States. Even those companies that fall short of our expectations are not experiencing a slowdown. **Delta Airlines**, for example, reported its profit would grow less than forecast not because of a lack of demand (business continues to grow) but because of rising labor costs, a typical by-product of full employment.

Finally, the last reason we are optimistic is because few others are. In our experience, the best returns don't result from a soaring economy. Rather, we would prefer an investing backdrop like today, where the economy is pretty good but consensus thinks it's terrible. Several indicators are showing that investors are very pessimistic. The closely-watched AAII Investor Sentiment poll touched its lowest point in three years in September. (It has often been a reliable contrary indicator.) Perhaps the most pervasive indicator of pessimism right now is the plunge in interest rates, with the 10-year Treasury bond falling below 1.5% (it was above 3% last November). In August, the 10-year yield fell below that of the 2 year note – a yield curve "inversion" – which can be a sign of a coming recession (which we do not expect). Falling rates are a worldwide phenomenon. *All* German sovereign debt instruments (from 1 month notes to 30 year bonds) now sport negative interest rates, meaning that investors are so scared they are paying the central bank to hold their money so long as they get it back at the end of the term. This is not a world in which animal spirits are running loose. Investors are confused by low or negative interest rates, scared by domestic political turmoil, and concerned about a trade war with China.

We view the market's preoccupation with these issues as an opportunity. We are not cock-eyed optimists, and we understand that these problems are real and difficult to solve, but they are also not the most important factors influencing the success of our portfolio companies. Impeachment, trade wars and negative rates won't affect the world's inexorable transition from cable TV to streaming technology, which directly benefits **ROKU, Disney,**

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Google and **Comcast**. Those issues won't affect the success of the new F-35 fighter jet from **Lockheed Martin** or the french fry volumes at **Lamb Weston** (see below). In short, a pessimistic market coupled with companies that continue to meet or beat their expectations create an attractive investing environment, and we are taking advantage of it this year.

One example of a recent opportunity is the drug company **Abbvie.** The good news is that Abbvie created and markets the best-selling drug in the world, Humira, a treatment for rheumatoid arthritis. The bad news is that Humira will go off-patent in 2023, putting more than half the profits of Abbvie in jeopardy. With four years to prepare for that event, Abbvie just announced the purchase of Allergan, the maker of Botox. The Allergan acquisition gives Abbvie significant new cash flows, but does not deliver a potential blockbuster Humira replacement. The stock, which was inexpensive to begin with, promptly dropped almost 20%. This is an example of a situation where real problems (the loss of Humira) and only partial solutions (the purchase of Allergan) caused a huge over-reaction and thus an opportunity. We purchased shares of Abbvie, a company that will continue to grow for at least the next four years, at 6 times earnings and with a 6.5% dividend yield. That valuation is 60% lower than the average pharmaceutical company, with more than twice the yield. Even with the loss of Humira in four years, the company will be large and profitable. And this is not a static situation. Over those four years, the company can discover new drugs, make another acquisition, or buy back a significant amount of stock. With such a low valuation, there are a lot of ways to win and we believe the stock is an opportunity to provide both income and capital appreciation to the portfolio.

Another new investment is **Lamb Weston,** a company you've probably never heard of, but you've almost certainly eaten what's come out of their factory. They are the world's largest publicly-owned maker of french fries, with McDonald's as their largest customer. After strong performance following its spin out from Conagra foods in 2016, Lamb Weston came under pressure as investors weighed the impact of new french fry factories on industry pricing. Although we think this could be a near-term headwind, the medium and long-term drivers of the business remain strong, with demand more than keeping pace with added supply over time. Exploiting the newly-built manufacturing base should allow the company to more profitably keep up with the growing demand of quick service restaurants both domestically and internationally. In short, McDonald's will get their fries more quickly, and Lamb Weston will make more money. We believe the drop in the share price in the quarter represented an attractive opportunity to own a quality business, and Lamb Weston shares are up about 10% since our initial purchase.

I think, especially at a time of strong performance, it's important not to ignore your mistakes. In the third quarter we sold **Wells Fargo** after holding it for more than three years. We made a slight positive return, but it greatly underperformed a rising market and most other financial stocks. Where did we go wrong? The thesis made sense: the company was selling at a wide historical discount when we bought it, and the company's century-old reputation as a conservative lender attracted us from a quality standpoint. It was one of the few financials, along

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with JP Morgan, that did not lose money during the 2008 financial crisis. But all that didn't matter in the face of management's consistently poor judgment in promoting policies that led to sales people taking advantage of their own customers. It seemed there was a negative announcement every month, with so many shoes dropping it felt like a Nike store in an earthquake. We should have known that relying on the company's century-old reputation was looking in the rearview mirror. While not fatal, there was pervasive mismanagement, and by the second or third "shoe," we should have walked away, barefoot.

We continue to hold roughly 35% of the portfolio in non-common-equity investments. As we've detailed in prior letters, these securities are a critical part of the safety and income side of the HIEP barbell. Currently, these securities are mostly floating rate preferred stocks. Floating rate preferreds (as opposed to fixed rate), are protected from the typical decline of fixed income securities in a rising rate environment, because their payouts will rise with rates. While protecting downside in a rising rate environment, these securities have also performed well in a falling rate environment, as they still have high dividends and are issued by companies with strong balance sheets. These companies include Morgan Stanley, Goldman Sachs, American Express and JP Morgan and their preferred securities have an average yield of 5.7%. We do not know how our nation's economic and political problems will resolve themselves. We suspect the current turmoil will persist. But, as this year shows, good returns are possible even in the face of bad headlines. Our recent strong performance has been helped by losing less when the market declines. Over the past year, there have been four down months for the market, and your portfolio has outperformed in each of them. Managing volatility remains a top priority for us, not just so we can minimize losses, but so we can take advantage of opportunities that present themselves during volatile moments.

We look forward to writing to you at the beginning of the new year.

Very truly yours,

Christopher C. Grisanti