CARMEL | CAPITAL PARTNERS

Q4 2017 Commentary

General Commentary

I see trees of green, red roses too
I see them bloom for me and you
And I think to myself what a wonderful world

I see skies of blue and clouds of white
The bright blessed day, the dark sacred night
And I think to myself what a wonderful world

What a Wonderful Word by Louis Armstrong

It is indeed a wonderful financial and economic world. Domestic equity markets are at all-time highs, economic growth has accelerated, U.S. corporations just received a tax cut, consumer confidence is at a 17-year high, and interest rates still remain relatively low.

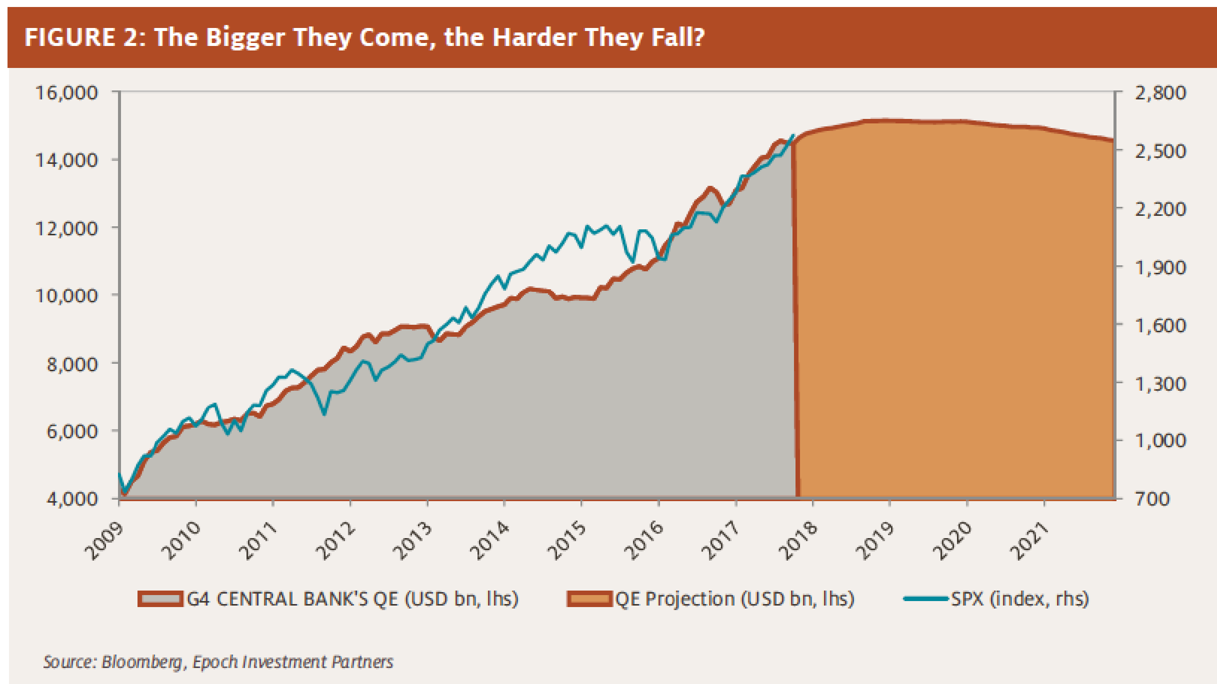
What's not to love?

The Q3 letter described our concerns about future returns for the broader market. These views have not changed. While the past 12 month's equity and fixed income returns have been attractive we still remain in a cautious stance. In addition to high valuations we're adding another item to the worry list – the Federal Reserve Bank's unwinding of its balance sheet.

This sounds complicated but essentially it means the tail wind provided to equity and debt markets is about to be reduced from a strong wind to a light breeze. The sizable support under the equity and debt markets is about to disappear. The Central Banks (here in the U.S. and Europe) have provided massive simulative forces since the 2008/2009 recession. The risk inherent in the markets is that we're in unchartered territory, the world has never seen this kind of intervention, and thus no one knows what happens when it ends. We believe the risks are even more elevated due to the large leverage in many areas of the market, coupled with elevated valuations.

We are not forecasting a market crash but are raising the caution flag and being vigilant in our monitoring of various markets for signs of distress.

The chart below depicts the expansion of the G4's (U.S., Europe, China and India) balance sheet. It shows that since 2009 almost fifteen trillion of financial stimulus has been added to the worlds four largest economies. As you can see the simulative effective is about to plateau, and begin a slow decline. It's this plateau and decline that worries us.



Equity

Our equity portfolios on average returned -1.0% during the quarter. For 2017, excluding cash, the performance of the underlying equity investments increased on average 5.5%. We are disappointed with these returns but continue to believe our portfolio at year-end contains investments that will deliver attractive future returns.

While we did not add any new positions in Q4 we did trim a number of positions as their weightings grew beyond what we're comfortable with. The proceeds from the sales will be redeployed into new investments we have on deck. Our expectation is we'll add two to three new investments in Q1. When the dust settles we expect the dollar amount allocated to equities will not change materially, however, there will be a handful of new investments in the portfolio.

Despite elevated market multiples we continue to have a full pipeline of new investment opportunities that we believe offer attractive medium and long-term returns.

Fixed Income

Our taxable fixed income investments delivered strong performance for 2017 with a +5.5% return. Interest rates (as measure by the 10 Year Treasury) were unchanged for 2017, which means our returns were mostly driven by a combination of current income and improvement in credit fundamentals. We added two new bond positions in Q4 – Sprint and Transocean. Both these bonds have a 5-year maturity, and were purchased at a 5.9% yield.

The above chart shows the spread between yields of triple BBB rated bonds, and yields of US Treasury bonds. The way read this chart is as follows: the higher number, the more investors are being compensated above the risk-free rate of return. The lower the number, the less interest one earns above the risk-free rate of treasury bonds. As you can see spreads are extremely low, and thus investors are being poorly compensated when owning corporate bonds. It's these low spreads that have made the current corporate fixed income environment challenging for bond investors. Despite all this we are still managing to find attractive opportunities. Today, our corporate bond portfolio has a current yield of 5.86%.

Our municipal bond portfolio delivered +2.5% returns in 2017. These returns are a little less than we anticipated, but be mindful that 2016 returns were very strong at +5.5%. As the year progressed we continued to experience an elevated rate of calls (bonds being redeemed early), thus it was challenging to remain fully invested during 2017. While it's always difficult to handicap the rate of early redemptions we expect reduced call activity in 2018.

We have significant concerns about Exchange Traded Bond Funds (ETF), and the growing role they play in the fixed income markets. These are mutual fund like products that hold all types of bonds, and trade daily like stocks. Our concern stems from what might happen in an environment where interest rates increase and too many bond ETF investors rush for the doors. In recent years, ETF bond funds have attracted sizable sums of investors' capital. The ETFs

themselves offer daily, hourly and minute by minute liquidity, however, the underlying bonds themselves are materially less liquid. Often when there is a liquidity mismatch it tends to produce bad outcomes. If too many investors suddenly decide to sell their ETFs, we expect to see large prices swings in the individual bonds we own as the ETF managers rush to sell their bond holdings to meet redemptions. Keep in mind volatility does not equal risk. If this comes to pass we still fully expect our bonds to continue paying income and return 100% of our capital at maturity. If we begin to see this type of activity unfolding, we will not hesitate to alert you.

Real Estate

We closed one additional real estate investment in Q4. This was a value add self-storage property in Las Vegas.

The four investments we closed in 2017 continue to perform as expected and are delivering strong results. We continue to expect returns from these investments to be in the range of 12% - 18%.

If you are currently invested in one of these transactions you will find a more detailed description in the "Real Estate Update" letter.

Private Equity

We closed our Little Caesars investment in mid-November. Now the real work begins. If you participated in this, a detailed update can be found in the "Private Equity Update" letter.

Concluding Remarks

Since co-founding Carmel Capital Partners, LLC a little over 16 years ago I have considered myself truly blessed. Every day I have the good fortune and privilege to arrive at our office excited, energized, and enthusiastic about the day ahead. I relished in the discovery process of investing, the pursuit of new and interesting opportunities, and the intellectual challenge of running my business. As a firm, we are blessed with wonderful clients and outstanding employees. I was able to do all of this with my partner, Anthony Josephson.

Thus, it's not possible to conclude this letter without a few words on a large change that recently took place at Carmel Capital. After 16 years wonderful years together, Anthony has departed to take over the family restaurant business. While this was sudden news to many of you, we spent many months planning for an orderly transition. It's extremely difficult to summarize a 16-year partnership in a few sentences so let me say this – I was extremely blessed to start a business and do what I love with such an honest, hardworking, intelligent, and trustworthy person. Just one of these qualities is extremely difficult to find in an individual, I was fortunate to partner with a person that possessed all of them. Let me simply say – Anthony you'll be missed.

While it is impossible to replace a 16-year partner, we’ve taken all the necessary steps to ensure a smooth transition, and ensure our experienced and capable team will continue to serve you, our clients.

Sincerely,

Russell Silberstein