CARMEL CAPITAL PARTNERS

11750 Sorrento Valley Road
Suite 110
San Diego, CA 92121

Q3 2018 Commentary

It's been a busy quarter….

General Commentary

It has indeed been a busy quarter.

On September 16th we announced the acquisition of Messner & Smith, a San Diego based investment management firm. For the past 34 years Messner & Smith has been investing client assets with a value driven philosophy very similar to Carmel Capital. The firm places a high premium on caring for its clients all the while delivering attractive investment results. Prior to closing the acquisition, I spent a number of months with the firm's founding Principal, Ellis Smith, and I am thrilled to have such a seasoned, smart, and capable investor joining our firm. Along with Ellis we welcome their Director of Research, Kevin Dukesherer. Kevin brings over 25 years of investing experience and previously held positions at firms such as Harris & Associates and RNC Capital Management. In addition, we have added Messner & Smith's trading and operations team.

Our research efforts and investment thinking have been enhanced with the addition of both Ellis and Kevin. We're enthusiastic and excited to begin working together on future opportunities. Please visit our website (https://carmelcapitalpartners.com/about/) to learn more about the new folks who joined Carmel Capital.

During the quarter financial markets continued to absorb news from both ends to spectrum. In the negative camp you have growing trade tensions (Europe, Canada, Mexico and China) in addition to rapidly rising interest rates. On the other end of the spectrum good news came in the form of a multi-decade low unemployment rate, elevated consumer confidence at levels not seen since 2000, and corporations/individuals still basking in the glow of tax reform. (see two charts below)

Good news won the day as evidenced by the equity markets surge to new highs during the quarter. However, as this letter is being written sentiment has shifted with higher rates and trade tensions weighing on the markets.

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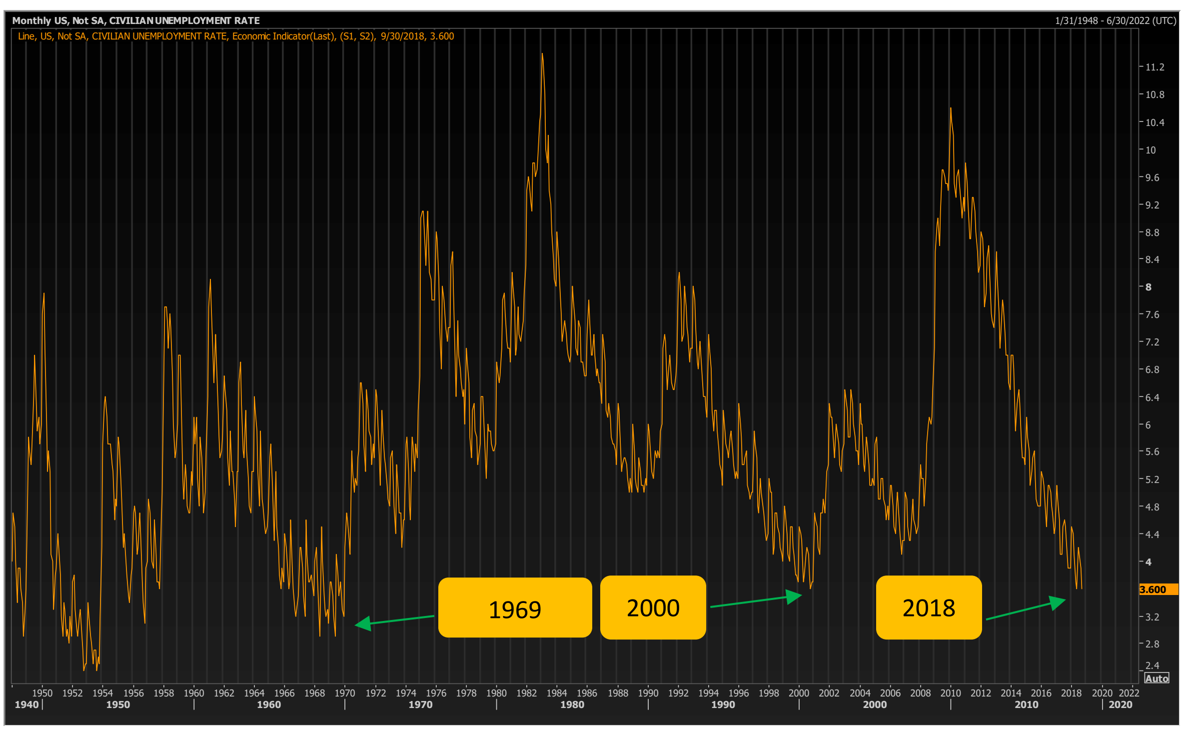
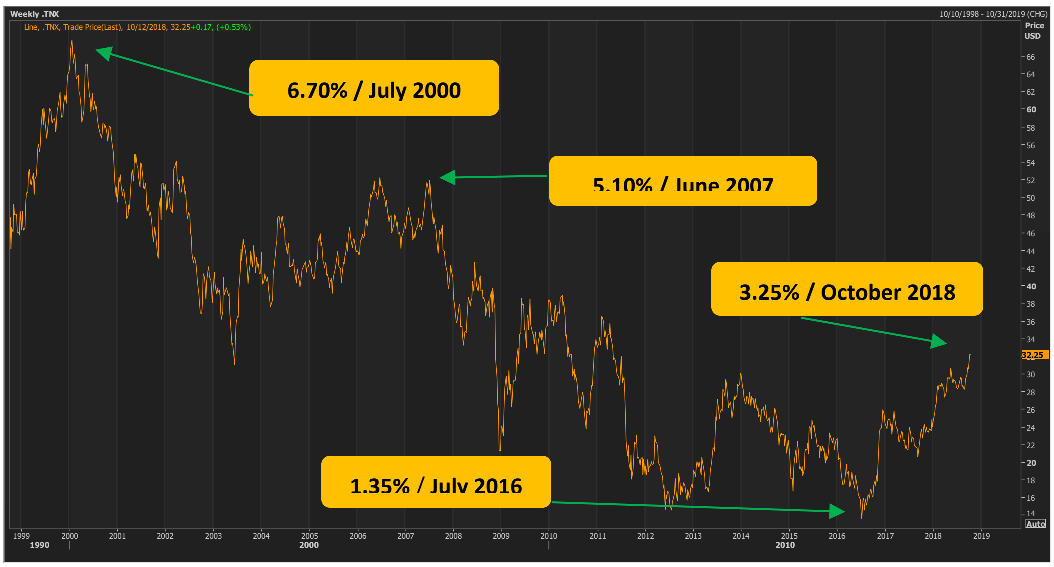
Consumer Confidence 1960 – 2018

Unemployment Rate 1960 - 2018

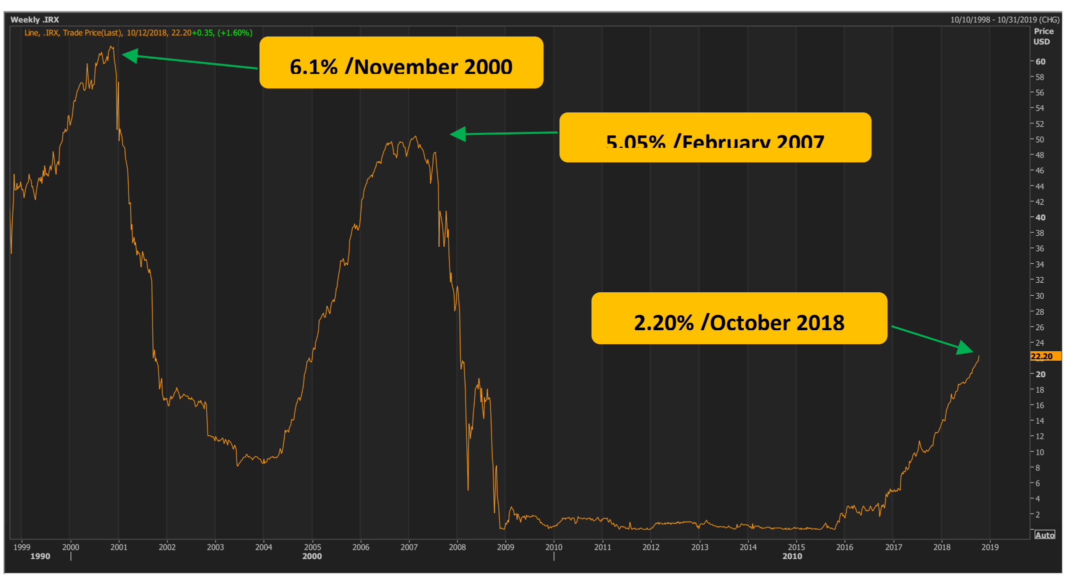


The below two charts show the increase in both short-term and long-term interest rates. The tough part of being an investor is knowing when higher rates will cause both the bond and stock market to reach a downside tipping point. To make matters more complicated, there is a view that higher rates are an indication of strong economic growth and investors should not view rising rates as a negative. Ordinarily this argument would have merit, unfortunately the Federal Reserves intervention in the financial markets over the past ten years makes this view tough to assess. You can see why it's becoming increasingly challenging to understand the current impact higher rates will have on the financial markets.

US 10 Year Treasury



US 3 Month Treasury



As expressed in our past three letters, we continue to maintain a cautious stance, with surging interest rates causing us to move the worry dial up a few settings. The Federal Reserve Bank has communicated a commitment to a "normal" interest rate environment, be aware "normal" is code for higher interest rates. By historical standards interest rates are still quite low, however, the amount of debt (on an absolute basis and relative to GDP) continues to move higher. Applying higher interest rates to growing debt levels tends to produce less than appealing outcomes. Hence the higher setting on the worry dial. If the first few days of the fourth quarter are an indication of things to come, we might have strap in and prepare for more turbulence.

It's worth repeating comments from the Q1 letter "We can address these risks by staying diversified through our various asset classes (equity, fixed income, real estate, private equity), maintaining a rigorous research process, and prudently allocating capital with a high margin of safety."

Equity Update

Our equity portfolios on average returned 2.15% during the quarter. For Q3 2018, excluding cash, the performance of the underlying equity investments increased on average 3.5%. Our year-to-date performance continues to be favorable with our equities advancing on average 11.25%

As the equity markets moved higher during the quarter we continued to sit on our hands, not our preferred position. Our preference is to always be allocating capital to attractive opportunities. However, the environment in Q3 was not conducive to making new investments. Our pipeline of on deck investments remains full, and if the volatility experienced during the first few days of the quarter continues, or we experience a material decline in the equity markets, we will deploy capital into our on-deck opportunities.

We did not add any new positions to the portfolio during Q2.

Fixed Income Update

Our taxable fixed income portfolios on average produced a 0.80% return in Q3 2018. As discussed above interest rates (as measure by the 10 Year Treasury) moved higher in the quarter from 2.85% to 3.23%. Short-term rates increased from 1.88% to 2.15% over the same period.

The increase in long and short rates are beginning to weigh on the bond market and starting to impact returns. However, please remember, rising rates will impact the price of our fixed income holdings, but will not impact the cash flow.

We added two new bond positions during Q2. Beacon Roofing, the bonds will deliver a 5.52% yield to maturity through 2023. We also added an MGM bond. These will deliver a 5.679% yield to maturity through 2026.

Today, our corporate bond portfolio has a current yield of 5.71% with an average maturity of 5.7 years. Our municipal bond portfolios on average delivered 2.25% returns in Q3 2018. Today we're able to purchase municipal bonds with maturity of 10 – 12 years at yields of 3.3% - 3.5%.

Real Estate

We did not add any new real estate investments in Q3 2018. Our real estate portfolio performed well in Q3 and a more detailed description and update can be found in the "Real Estate Update" included with this letter.

Private Equity

A detailed update can be found in the "Private Equity Update" included with this letter.

We have a new investment opportunity currently being developed and expect to have more information available later in Q4.

Concluding Remarks

Our cash levels continue to be above historical levels. While holding cash at the beginning of the year was a drag on investment performance, we're now happy to be positioned as we are. We continue to be patient and wait for opportunities that meet our criteria – quality franchises with a margin of safety. Market timing and economic forecasting are not part of our day to day decision making. We make decisions one investment at a time and patiently wait for attractive opportunities to come our way.

The market turmoil in recent days leads us to believe there will be opportunities to deploy capital in the months ahead.

Sincerely,

Russell Silberstein