5C CAPITAL MANAGEMENT, LLC

> *In the midst of chaos, there is also opportunity*
>
> *- Sun Tzu*

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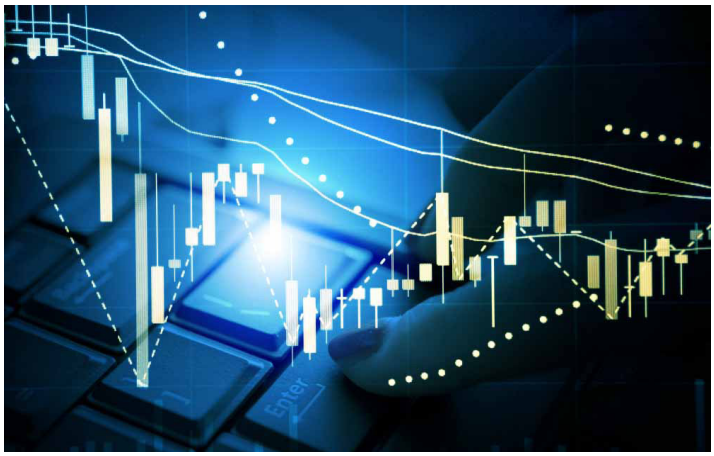


Safe Yield - At What Cost?

Given the strong global equity markets in 2019, let us begin with a view of the less exciting bond and fixed income markets. These investments are used to stabilize portfolios and provide a significant amount of income for our clients. When interest rates move significantly, it's tempting to panic and chase yields, or sell declining investments. Looking forward versus reacting to current events requires critical thinking, strategy and policy. While interest rates rarely stand still, their movement since last fall represents a fairly dramatic shift. The 10-year Treasury yield round-tripped from 2.40% in January 2018 to nearly 3.25% in October back to 2.40% in late March 2019.

Sometimes simplest is best

We typically hold short-term Treasuries or cash equivalents for a variety of liabilities or for reserves, not in weightings typically associated with that of core portfolios. However, this is where we find value given the current flat-to-inverted yield curve (especially within short and mid-term ranges). Short-term Treasuries yielding approximately 2.40% - greater than 90% of the 10-year treasury yield; with full liquidity, compare favorably to much longer-term securities.

Focusing on short-term Treasuries has several key benefits. One, of course, is preserving liquidity to take advantage of more attractive opportunities as they occur. A shift toward easier Federal Reserve policy will tend to restore the yield curve to its more normal upward slope, as it not only brings short-term rates down (by definition) but also tends to push longer ones

up as the market worries more about inflation. Investors have increased their attention to municipal bonds, since the passage of the late-2017 Tax Cuts and Jobs Act, which has limited the deductibility of state and local taxes (SALT) to $10,000. The reasoning is simple enough. If you can't use your state and local (including property) taxes to reduce your federally taxable income, you need to find other ways including using municipals to generate tax-free income.

However, value is currently difficult to find in the tax-free space. Investors often seek yield with "legacy" municipal bonds - high-coupon bonds issued years ago. Many of these bonds have call features exercisable currently or the near future. Often purchased at steep premiums, investors risk losses or minimal returns if the bonds are called away; an increasing likelihood in today's low interest rate environment. Although investors may avoid call risk purchasing non-callable munis, known as "bullets", we feel this market is currently overextended and with modest exception has not compensated investors for the risks involved:

- **LIQUIDITY:**
Treasuries are among the world's most easily transacted securities. Munis also have great liquidity but are more thinly traded – an unanticipated sale may result in pricing pressure.

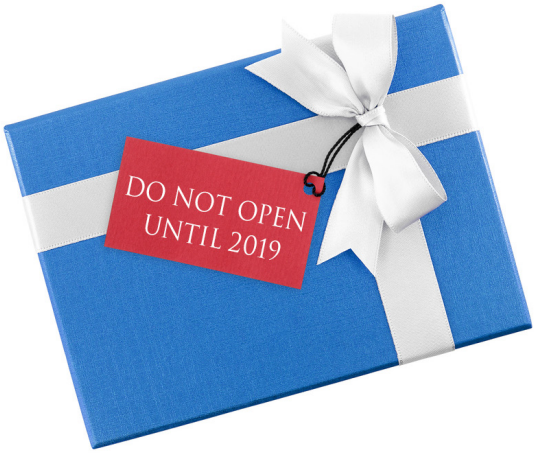
- **CREDIT:**
We consider highly rated munis safe investments, but recognize the difference between the United States Treasury which has the ability to print money and State and Local governments which rely on the power of local taxation and other revenue sources.

- When building a diversified municipal bond portfolio, we typically incorporate issues outside a client's resident state. This does not necessarily enhance yield, since income earned on out of state municipal bonds are subject to resident state tax. However, this decreases single state risk and may strengthen the credit profile of the portfolio. Interestingly, since income from Treasuries is not subject to state and local tax, their after-tax yield currently compares favorably to many short and mid-term munis.

The yield yo-yo and its effect on stocks

Last October, with the 10-year crossing 3.20%; the equity market turned quickly, erasing solid returns for the year. Until rates hit that level, traders bias was "risk on" and that strong earnings growth was more than enough to offset the effects of higher yields. As the markets unwound, selling begat selling, compounded by the Federal Reserve's path of rate increases. Traders selling put options into a consistently rising market suffered large losses during the 20% equity market reversal. A small number of hedge funds collapsed in a matter of days. Those selling puts to the desperate buyers had to hedge themselves by shorting stocks to protect against further downturns.

The market's breakdown ended not with a whimper but a bang on Christmas Eve 2018. Other than a



few short sellers, few envisioned that the S&P 500 would be negative 19% for the fourth quarter, 14% for December and 11% for the full year.

For those that did not overreact, one holiday present had "Do Not Open Until 2019" written all over it. 2019's rally began on the heels of the 10-year's retracement to 2.74% on Christmas Eve. Again, for those with a calmer view of the opportunity presented

it was time to rebalance portfolios away from bonds and toward stocks.

The rally during the first quarter 2019 erased the fourth quarter rout. The first two trading days in January hinted that the late-December recovery might not follow through, with the S&P 500 falling over 2%. However, the Fed appeared to pirouette, seeing that not just markets but economic data were signaling an economic downturn.

On Friday, January 4th, current Fed Chairman Powell was joined by former Chairs Ben Bernanke and Janet Yellen in Atlanta for an interview with Neil Irwin of The New York Times[1]. As he began, Powell, previously seen as a hawk, noted that "we will be prepared to adjust policy quickly and flexibly" and that "the markets are obviously well ahead of the data...And I'll just say that we're listening carefully to that...sensitively to the message the markets are sending." Yellen and Bernanke concurred that markets were nervous about slower growth and implied that the Fed would be ready to act as necessary to reassure them – the former chairs calmed investors with their support for Powell.

The market received the go-ahead it had been seeking. The S&P 500 rose over 3% that Friday. By the end of the quarter, the 10-year yield had returned to its January 2018 level, while the S&P 500 was within a couple of percentage points of its September 2018 high. During 1Q 2019, US small-cap growth was the strongest performing equity sector - gaining over 17%. Generally, growth outperformed value and all equity sectors performed strongly. Most importantly, those who stuck with a long-term investment plan and rebalanced appropriately during the late-2018 selloff were rewarded.

Is there a major dispersion among equity valuations?

Common valuation methodology depends on three basic inputs: this year's expected profits, the discount rate (a mix of current interest rates and a company's predictability) and the projected long-term growth rate. Falling discount rates push valuations higher, while lower growth does the opposite.

While the long-term view shouldn't change, the nearer-term outlook has gotten murkier. The powerful stock rally would suggest at least a modest rebalance toward bonds, but a 10-year yielding only around 2.5%, 75 basis points less than it paid a handful of months ago, doesn't seem particularly enticing.

Growth and momentum stocks, as measured by the Russell 1000 Growth Index, currently trade at a price/earnings ratio of 25 with a dividend yield just over 1%. This represents a historically high multiple and a correspondingly low yield. Meanwhile, the price/earnings ratio on large-capitalization value stocks, as measured by the Russell 1000 Value Index, sits at only 17, accompanied by a dividend yield of over 2.5% - we continue to see value in this sector.

Keys going forward

The Fed's accommodative stance and hopes for resolving the trade dispute with China provide modest optimism. However, this could reverse quickly. Fears of an unchecked deficit, unsuccessful negotiations with China and North Korea and renewed signs of a slowing economy, could all reverse 2019's rally. Germany has returned to negative interest rates and Brexit has been pushed back yet again. Despite these significant and well-broadcast risks, we see opportunities. We remain committed in particular to international stocks and to a smaller degree emerging markets, where valuations remain attractive.

[1] *Transcript provided, "lightly edited," by The Wall Street Journal.*

How will the new tax law affect the economy?

The Tax Cut and Jobs Act of 2017's apparent objective was to help low- and middle-income earners in low-tax states at the expense of high earners in high-tax states.

The tax law reduced the Federal rates on most, though not all, tax brackets by 2-3%. It also nearly doubled the standard deduction, including an increase from $13,000 to $24,000 for couples filing jointly. For a typical family earning in the $50,000-$75,000 range, this was clearly a big help. But the elimination of the personal deduction (just over $4,000 per family member in 2017) more than offset this benefit for larger families.

While the tax law did restore the standard and personal deductions for certain higher-earning filers who had not been able to claim them previously, it likely penalized these earners by limiting the amount of debt allowable for mortgage deductibility, from $1 million to $750,000. Even more severely, it penalized them by limiting the deductibility of state and local taxes (SALT), including property taxes, as we discussed earlier.

Corporate earnings benefited significantly last year from the 2017 tax legislation. But what does that mean now? Many economists felt the 2018 benefits were largely a one-time "sugar high," with the resulting trillion-dollar deficit increase likely to do more harm down the road.

Should we worry about the yield curve's implications?

Market followers often contend that an inverting yield curve—where short-term interest rates exceed long-term ones—can be a good predictor of recession. It makes sense on two levels.

First, companies do not borrow short-term money for major, multi-year investment projects. They borrow long, or at least they should, on the theory that you are supposed to match assets and liabilities. When long-term rates are falling, since interest rates are the price of money, it means demand for long-term capital is probably falling. Businesses are getting less confident and seeing fewer opportunities.

Second, think about the yield curve from a bank's perspective. Banks borrow short-term money (a consumer deposit is nothing more than an overnight loan to the bank) and lend much longer-term. The normal upward-sloping yield curve, where rates go higher as maturities get longer, favors the bank's business model. An inverted curve does the opposite. It makes banking essentially unprofitable, and if banking is unprofitable, capital gets harder to come by, even when rates appear low.

At most, these considerations tell only part of the story. Sometimes long-term rates fall only to rise again quickly. Consider, for example, the recent volatility we've already discussed. A bit more inflation worry might actually be a good thing—it might spur businesses to borrow and invest and the inverted curve could quickly disappear. Should the Fed continue to soften its overall view and start lowering rates, instead of raising them, the yield curve would likely return to a more traditional profile.

Are REITs a bubble?

We don't normally think of real estate investment trusts (REITs) as momentum stocks. They typically move only about 50-70% as much as the overall market. 2019 has been different – during the first quarter, the $1.2 trillion universe of REITs gained about 17%[2]; matching small-cap growth stocks and comfortably beating the S&P 500. It's doubtless part of the renewed hunger for yield, since REITs must pay virtually all their cash flow in dividends to avoid taxation at the shareholder level and thus often pay double-digit income. But does that make it right? Or is the rush into REITs a sort of mini-bubble that may turn out badly?

A slowing economy is rarely good for real-estate investments, and some areas—the Northeast in particular—are experiencing slowdowns. That said, less-expensive parts of the country are doing well, as people are taking advantage of greater affordability[3].

In the zone?

We've already seen several areas, notably munis and REITs, where investors are scrambling for total return, especially with favorable tax treatment. One alternative investment drawing a lot of attention—and confusion—is the opportunity to participate in certain economically disadvantaged areas. These so-called "opportunity zones" may turn out to be outstanding ways to help reverse the nation's perilously growing economic inequality. Or they may turn out to be sleight-of-hand, helping some of the wealthiest investors save taxes while making investments they were going to undertake anyway[4].

There are over 8,700 low-income zones (including over 500 in New York) qualifying for favorable tax treatment as part of the 2017 tax act. If investors roll realized capital gains into development in these areas, they can delay paying taxes on those gains, and they will pay no capital gains on opportunity-zone investments held for at least a decade.

The controversy revolves around zone definition. Depressed rural areas desperately need investment and would be unlikely to get it without policy like this. (It is unclear whether they will receive it even with the legislation). Many think it's more likely the investment will go into urban areas already experiencing early stages of gentrification—think about outer boroughs in New York City and neighborhoods in Washington, DC, Los Angeles and San Francisco. States designate the areas and then Treasury and IRS approve them. But while a lot of people are paying attention—a recent IRS hearing reportedly had prospective investors lined up outside the building—relatively few have invested as of yet[5]. The delay is likely because of communication bottlenecks such as these.

In mid-April, the Treasury and IRS released its second round of proposed updates designed to clarify the requirements for and tax treatments of opportunity-zone investments. Clarify is a relative term: the proposal document has 169 pages. The agencies requested comments on the updates, with a public hearing early July. Some key issues include different treatments for operating businesses and real-estate investments, the time frame required for putting cash to work (generally 30 months), and nuances involving the 10-year holding period required to avoid any capital-gains taxes[6]. We will monitor the process and keeping you apprised.

We wish to thank our clients for their trust and confidence and encourage you to contact us with questions or commentary regarding this letter. Please inform us if there has been a significant change in your financial circumstance or if you have any questions regarding your portfolio.

Warm Regards,

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[2] *Bloomberg data.*
[3] *"Cheaper Housing Options Boost Homeownership in Some U.S. Metros," Bloomberg, March 5, 2019.*
[4] *"Will 'Opportunity Zones' Help Poor, Rich, or Both?" Bloomberg, February 14, 2019.*
[5] *"Opportunity Zones Knocking, but Few Answering the Call So Far," Bloomberg, April 10, 2019.*
[6] *"A Clearer Path to Opportunity Zones", April 2019 white paper, Duval & Stachenfeld LLP.*

There is a pattern in nature that portrays ongoing growth. Known as the Fibonacci sequence, it is seen most clearly in the intriguing spiral form of the Nautilus shell. From a mathematical standpoint, it is startlingly simple: each number in order is the sum of the two previous numbers: 0,1,1,2,3,5,8,13,21,34 and so on. Yet in terms of structure, it is sturdy, strong and reliable.

For 5C Capital Management, this unique combination of growth and stability is a powerful representation of our approach. The focus of our cumulative experience is to establish goals and implement strategies that support current financial stability while consistently building toward the long-term financial growth you aspire to for your own lifetime and for future generations, as well.

Much like the Nautilus is built on an unfolding and interwoven series of C shapes, so is the core of 5C Capital Management. Our clients rely on us to provide an exceptional level of:

- **COMMUNICATION** - We listen attentively, share ideas clearly, operate transparently and maintain connectivity.
- **COLLABORATION** - We work together with you and the professionals that comprise your advisory team to ensure that your concerns are addressed as they arise and your strategy adapts to changes in circumstance warranting such adjustment.
- **CRITICAL THINKING** – By incorporating independent fundamental analysis, we maintain the objectivity needed to provide a full spectrum of unbiased solutions. We plan for a range of potential scenarios; develop a structured, flexible strategy, and take timely action.
- **CREATIVITY** - Every client has a unique set of circumstances and goals. Our experience and common sense approach results in solutions that are customized for each client's circumstance.
- **COMMUNITY** - This cornerstone of our approach refers both to 5C's access to and use of a wide community of tax experts, attorneys, business consultants, and other specialists, as well as our dedication to understanding our clients' special commitments to community through philanthropy and support of cultural and educational initiatives and institutions.

We embrace our fiduciary obligation to clients and invite you to discover how 5C Capital Management, LLC is highly qualified to guide and advise you through this complex process.

YOUR NEEDS, OUR INSIGHTS

5C Capital Management staunchly maintains its independence and is not affiliated with any mutual fund family or similar investment pool; we are not required to commit client capital to any specific strategy or product. Therefore, we are free to choose from a broad array of money managers and asset classes to implement strategy, while limiting transaction expenses and management fees.

We are experienced in assisting clients in all the following matters:

- **INVESTMENT MANAGEMENT**
- **CHARITABLE GIVING**
- **TAX PLANNING**
- **MANAGING SPECIAL NEEDS**
- **RETIREMENT PLANNING**
- **ESTATE AND TRUST PLANNING**
- **SUCCESSION PLANNING**
- **HIGHER EDUCATION PLANNING**
- **LIFE TRANSITIONS**

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