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Market View Update

What Is Happening?

So much to tell you:

- Inflation is hanging in the 2.7% range – so nothing new;
- The stock market has pulled back from it's 1st Quarter partying with the S&P 500 down almost 4% this month;
- Our average portfolio is almost flat in April and nearly 6 percentage points ahead of our benchmarks for the year, so we're quite steady;
- We continue to buy more growth dividend stocks in the utilities (primarily electricity providers), defense, South American beer and some preferreds where we see extra value;
- We take a deeper dive on a couple of stocks; and
- Our new website article on **Taxes and Investing**.

Introduction

It's been a see-saw year now that April has slapped the market back toward reality – if our country's economic growth means inflation stays higher than 2%, then interest rates need to adjust accordingly. Further, as long as employment remains this strong and inflation remains higher than 2%, why would the Federal Reserve lower rates? We continue to keep an eye glued on the next labor productivity reading in early June for further evidence artificial intelligence continues to push productivity, employment, growth and inflation.

We stick by our call that the 10-year interest rate will settle around 4.5% (currently at 4.7%) with short-term rates settling around 3-3.25% (currently at 5-5.25%.) The stock market still has not fully accepted this scenario and we continue to position for outcomes very close to this world.

Toward that end, two important companies in our portfolio reported results this week and let's explore how KREF and LMT are doing.

KREF

Part of the KKR private equity/lending empire built on superb credit analysis, we rely on KREF's analytic strengths in building their loans to office, industrial and apartment buildings. The big issue has been their office loans (about 22% of all loans) and one life sciences project.

We all know the issue in the office market – only the best class A buildings have good demand; and KREF's portfolio is 93% Class A office loans with one class B loan on its books. Moreover, the office loans look likely to resolve in a reasonable way with the life sciences development also likely to work out well. KREF has taken ownership here and in a couple of other situations, which means they now have to operate, lease and manage these properties. Having to bear operating costs drags on the stock's performance, but the good news is that KKR has the internal support and expertise to manage through this moment where other lenders feel more pressure to sell at steep discounts.

Soon, we will feel more aggressive about this stock as we see an almost full recovery coming plus new growth. We look forward to reading ACRE's 1st Quarter report for further insight to the office leasing market, which started to recover in December, 2023.

Lockheed Martin (LMT)

LMT reported further progress on several fronts that helps us see good value here. As much as we detest war, it comes no matter how we feel, and countries must defend themselves. LMT is among the premier providers of weapons that need replacement – fighter jets, missiles and ammunition. On the fighter jet front where LMT has struggled with the F-35 program, the current upgrade cycle appears on track again. While US military orders shrunk this year due to those earlier issues, foreign demand has picked up the slack.

We see fighter jet demand growing into 2025 despite an impending new drone fighter program that was awarded to other competitors this month. Importantly, those are the design contracts and we believe LMT will have an opportunity to insert its expertise in manufacturing (along with Northrup Grumman, the other major weapons competitor who lost the design phase contract) once the design is finalized. Whether this program threatens or creates opportunity for LMT remains unclear on several fronts. We will monitor.

In LMT's missile systems, the future is far rosier and clearer. Not only does Ukraine need more of its HIMARS and other missiles, LMT was also awarded the lead on a new hypersonic missile system – a cutting edge defense contract that should grow in value over time.

On the negative, LMT took a loss on a classified program. That's going to happen with any company this involved in new systems development as the continued need to find new solutions means more contracts. As long as the world remains this volatile, owning a premier defense contractor or two makes very good sense. LMT is among the best.

Despite any near-term headwind over losing the drone design contract, orders have ticked higher as militaries throughout the world need to restock.

Taxes and Investing

As part of our website refresh (coming soon!), we present our guide to taxes and investing:

Taxes and Investing

Introduction

All of us would rather pay zero taxes, or at least push them off. However, when it comes time to taking profits, we see too many people prioritize taxes over their investment returns and that's almost always a worse choice.

Let's explore why people tend to act this way and how we might look at all of this more rationally.

Tax This, Tax That

Yeah, we pay a lot of taxes through many mechanisms:

1. Sales taxes on many purchases;
2. Property taxes, if you own any physical real estate;
3. Payroll taxes, if you're an employer;
4. Social Security, disability and/or self-employment taxes;
5. Tariffs on imported goods (we pay any tariff, not the company/country sending us the goods);
6. Miscellaneous taxes (e.g. energy, municipal services and/or phone line taxes); and
7. Investment taxes (income and capital gains).

Income taxes are really just a part of what we pay each year – where does it all go?

Like most industrialized countries, our tax dollars support all manner of programs and efforts to make our country a better place. Does it work well? That's one to ponder. In our corporate careers, we've witnessed all sorts of waste and fraud. Consider any company that barely makes a profit or loses money – are they spending money any more wisely?

While it's easy to see we can do a lot better both inside and outside government, the results have benefitted our society over time. Do we do it really well? Probably not, but better than most; and more than enough to remain the world's dominant economy.

We are not supporting any particular tax policy, but rather noting that we deal with taxes on an almost daily basis in our lives. Of all the taxes we face, the steepest are typically income taxes, which can run as high at 40% of the next dollar we earn.

> Important Note: Our income tax system is graduated. That means if the first $20K we earn is taxed at 20% and 25% on the rest, we are not being taxed at 25% on the total amount, just each dollar above $20K.

Among the next highest tax rates are capital gains taxes, or the profits we make when we sell a share of stock for more than we paid – we owe a tax on the profit that can range from 15% to 50%, depending on a variety of factors, including how long we've owned the stock plus any state taxes.

When taxes are that high, should they impact how we invest?

Tax Rates and Behavior

Those of us who pay federal income taxes know anything we can do to reduce those taxes is a good thing. The tax code allows us to take deductions where we can find them because these taxes can be very high when compared to others.

Income tax maneuvering also promotes a mindset that often affects how we look at other taxable events like receiving income from our investments.

Mark's Grandmother

Let me share a story – my maternal grandmother was left quite wealthy when my grandfather passed, but she had no education about investing other than hearing what my grandfather said for years – don't pay taxes until you absolutely have to.

Whenever I tried to help, I was immediately met with a wall of, "will I have to pay taxes?" My answer was always, "yes, and only after the money is in your pocket." She refused to consider any taxable investments and she paid no income taxes each year anyway. Her fixation on taxes meant she drastically underperformed the returns she should have earned because taxes drove her choices.

Let me illustrate how she missed out – to avoid taxes, there are certain investments available in the market. The most popular are Municipal Bonds backed by local or state government, or direct revenues from their projects. Interest from these bonds are tax-free federal income; and if you live in the state where the bonds are issued, you also pay no state tax either.

That sounds really attractive until you see the rates these bonds pay are about 40% lower than taxable bonds. Why? Well, the highest income tax payers are the biggest buyers of these because they pay about 40% on the next dollar of income they receive. Those buyers are willing to accept up to 40% lower interest payments because they do not have to pay the 40% income tax to the government – or what the municipal bond market calls "tax equivalent yield." You may have noticed this term from our weekly bond pricing charts and this is why and how they are calculated.

High income tax paying investors are happy to receive less than market interest from these bonds because they pay no tax on interest received from them. My grandmother who paid no tax anyway, always received about 40% less than she could have earned by buying taxable bonds of the same risk while owing between 0% to about 15% in income taxes. That's leaving a lot of money on the table because taxes drove her investment choices instead of profits.

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Looking At the Whole Picture

When we analyze an investment, taxes are not relevant for one reason – the risk of any investment has nothing to do with our individual tax situations.

Also, we never buy securities with "phantom income", or income that triggers taxes when we received no dollars in our accounts.

> Important Note: Phantom income is typically a problem in exchange traded or mutual fund investments where fund managers buy and sell securities without distributing the gains to us. Instead, they buy new securities and pass the tax burden to investors. While it is correct that we do owe tax on profits made from buying and selling stocks, the fund manager not distributing to us creates a situation where we pay the tax today and hopefully receive our money later – yuck!

For any investment to be attractive to us, we look at the returns we can expect from that investment measured against its risk. **Whatever taxes we later owe should never drive the risk we are willing to take** outside of certain exotic situations that do not apply to any of us today.

But Now I Owe Taxes on My Profits!

We know some financial advisors do not want you take a penny from your account so it can grow and we believe that's wrong. Rather than shift the burden to you, we will liquidate whatever we need so you can pay your taxes from profits in your investment account. The process is simple – just transfer cash from your Schwab Account to your bank account and if you have questions, we all always here to help.

Tax Advantaged Investing (IRA and 401K Type Accounts)

If you are willing to lock up your investments and/or limit how the money is later used, there are variety of government sponsored investment accounts that allow us to defer or pay no taxes if we are willing to not touch that money for long periods of time:

1. 2 types of IRA accounts
    a. A traditional IRA where you pay no income tax on the dollars you contribute to defer those taxes until your 60's (this can be most attractive for younger investors); and
    b. A Roth IRA where you invest after-tax dollars and never pay taxes on gains if you wait until you 60's (can be most attractive for those nearing retirement.)
2. A Variety of Accounts for Minors
    a. College savings accounts like a 529 Plan limit what you can buy (a big drawback); and
    b. Trust accounts like the UTMA for situations that may include special needs planning.

> Important Note: Taking money early from these accounts can trigger penalties unless you lend it to yourself and pay interest back to your account.

These programs can create long term value by using what the government gives us. We must also choose vehicles appropriate to our individual situations.