Fiduciary Perspective

FIDUCIARY™ TRUST

Third Quarter 2024

Donating Illiquid Assets to Donor-Advised Funds

Donating non-publicly traded, illiquid assets to a donor-advised fund can be an effective way to increase your charitable impact. A well-known charitable giving strategy involves contributing public company stock with a low tax basis to a donor-advised fund (DAF) and then gifting the proceeds to charities over time. This strategy entitles the donor to a charitable income tax deduction for the DAF contribution while avoiding the realization of embedded capital gains. Donors may not be aware, however, that this strategy can also be used to contribute a range of illiquid or complex assets to DAFs.

The ability to use a donor-advised fund to receive a range of illiquid, non-publicly traded assets provides an important opportunity for donors to enhance their charitable impact and potentially decrease their tax liability. While the most common DAF contributions are cash and publicly traded securities, these are far from the only options.

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Q3 Market Outlook:
Market Distortions, Artificial Intelligence, and Politics

July 2, 2024

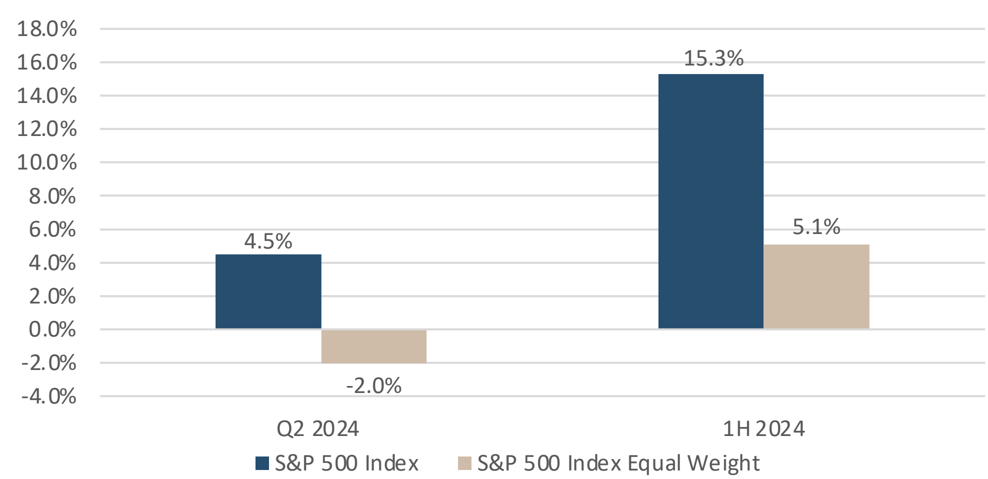
With the year half over, U.S. equities have once again distinguished themselves by lapping their international developed market peers, with the former gaining 15.3% and the latter 6.0%.[1] During the second quarter, the S&P 500 Index gained 4.3%, while the technology-heavy Nasdaq jumped 8.5%. Global equities gained 1.3%, assisted by a strong showing from emerging markets, which advanced 5.3%.[2]

From a business cycle perspective, the U.S. remains in fine fettle. Employment, industrial production, and purchasing managers' indexes in both the service and manufacturing sides of the economy suggest growth remains the order of the day. Remarkably, the housing market seems to be dealing well with higher interest rates, as a shortage of inventory helps sustain rising prices. On the inflation front, the rise in consumer prices continues to remain stubbornly above the central bank's target, complicating any interest rate relief investors anticipate. Indeed, an oft-quoted measure of the economy's growth, the Federal Reserve Bank of Atlanta's GDPNow nowcasting model pegs second quarter growth at 2.3%.[3]

All May Not Be as It Seems

While returns of the S&P 500 Index are impressive this year, it is impossible to ignore how top heavy the index is and the dominance of two industry sectors. From a return perspective, these distortions are clear when comparing returns on a market-capitalization versus an equal-weight basis. The difference between the two is important: The size of a company is what dictates its weight in the market capitalization version, whereas the equal-weight index represents a proxy for the returns of the average stock.

Exhibit A: S&P 500 Index Market Cap vs. Equal Weight Total Return



Source: Bloomberg, Fiduciary Trust Company. Data as of June 28, 2024.

Video:

View our market outlook webcast at:
fidtrustco.com/market-outlook

[1] Returns of U.S. equities are measured by the S&P 500 Index and global equities are measured by the MSCI All Country World x US Index via Bloomberg.
[2] Global equities are measured by the MSCI All Country World x US Index and Emerging Markets are measured by the MSCI Emerging Markets Index.
[3] For GDPNow see https://www.frbatlanta.org/cqer/research/gdpnow. As of June 28, 2024.

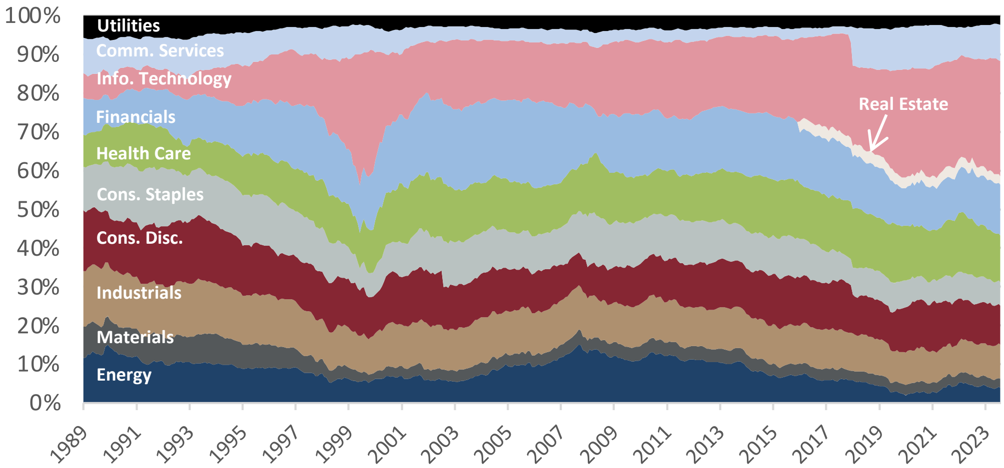
On a year-to-date basis, the oft-quoted market-capitalization version of the index is up more than three times that of the equal-weight version. For the quarter, the results are even starker, as the average stock has declined while the market-cap version registered an impressive return (Exhibit A).

The record run of the S&P 500 is impressive this year as it has logged more than 30 record-high closes.

The market's concentration sits primarily in the technology and communication services sectors, which together now account for 41% of the index, a level last reached when the index peaked during the Y2K technology boom (Exhibit B).[4] The importance of the leadership of these two sectors is seen when looking at the performance and composition of the top 10 names in the index. Year to date, the top 10 names are up 28.5%, while the overall index is up 15.3%.[5] Technology and Communication Services account for roughly 76% of this top tier of the benchmark.[6]

The record run of the S&P 500 is impressive this year as it has logged more than 30 record-high closes

Exhibit B: S&P 500 Sector Weights



Source: Bloomberg, Macrobond, Fiduciary Trust Company. Data as of June 28, 2024.

All Things AI

The drivers of performance this year are a continuation of those of 2023. Artificial Intelligence (AI) has seized the attention and capital of investors. Undoubtedly, the symbol of all things AI is chipmaker NVIDIA. This company, which was previously known as a chipmaker for online gaming devices, has found new and growing markets as companies realized that their chips are perfectly suited for generative AI's large language models, autonomous vehicles, crypto mining, and data center platforms.[7] NVIDIA's share price has rocketed more than seven-fold since the start of 2023. Its corresponding weight in the S&P 500 Index has leapt from 1.11% to 6.34%.[8] Put another way, the company has added $2.6 trillion in value since the

[4] Y2K was the acronym for the "Year 2000" capital spending bonanza that inspired an epic bubble in the share prices of technology and tech-related companies. Like all capital spending booms it was followed by a spectacular bust.
[5] Data from Bloomberg. The top 10 index is the S&P 500 Top 10 Index and market index is the S&P 500 Index.
[6] Data from S&P Dow Jones Indices and S&P 500 Top 10 Index, as of May 31, 2024.
[7] NVIDIA Newsroom and Hoovers via Bloomberg.
[8] Weight data from Morningstar proxies by weight in the iShares Core S&P 500 ETF. Current value as of June 24, 2024.

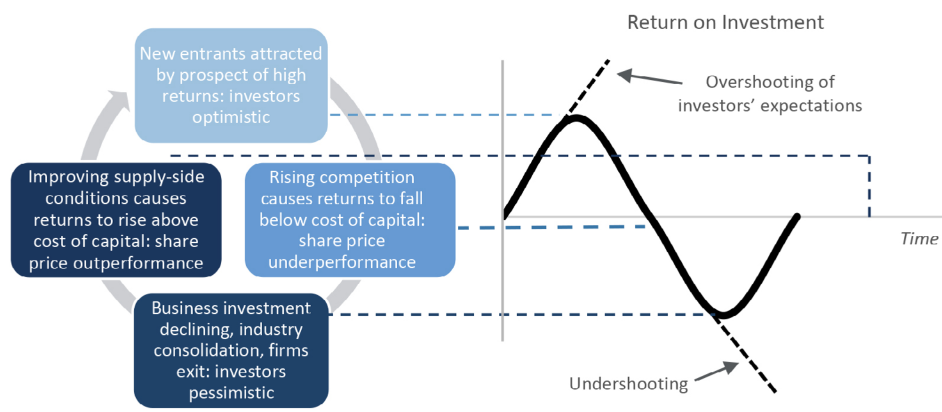
Capital spending cycles across industries exhibit remarkably similar features

start of 2023, which is $200 billion more than the combined market value of Exxon, J.P. Morgan, Procter & Gamble, and Home Depot.[9]

The AI boom has also pulled the share prices of adjacent companies such as Microsoft, Amazon, and Google higher. The parabolic performance of companies in this space raises questions about whether it is sustainable. How, then, is one to comprehend that which appears incomprehensible? If the boom in AI stocks represents a surge in the capital spending cycle related to this sector, then examining the nature and features of the capital spending cycle might shed light on the current state of play. It also might hint at what is to come.

Capital spending cycles across industries exhibit remarkably similar features. Whether it be shipping, mining, energy extraction, paper production, or computer chips, the cycle generally consists of four phases that turn from virtuous to vicious (Exhibit C).[10]

Exhibit C: The Business Investment Cycle



Source: Edward Chancellor, Marathon, Fiduciary Trust Company.

The Phases:

- *Phase 1:* Favorable supply conditions push returns well above the cost of capital, creating shareholder wealth, which drives strong stock performance.
- *Phase 2:* High returns attract new competition seeking to claim market share. This attracts investors seeking to profit from market conditions.
- *Phase 3:* Rising competition and investment generate an unfavorable supply-demand dynamic that causes returns on investment to eventually fall below the cost of capital. This results in disappointment from the newly arrived investors and share prices fall.
- *Phase 4:* With returns on investment no longer being economic, firms stop investing and, in some cases, divest. Some companies leave the industry and others are consolidated into large entities. Disappointed and sitting with losses, investors abandon the industry.

[9] Market capitalizations were taken as of June 24, 2024, via Bloomberg.
[10] Taken from a 2022 presentation by noted author and journalist Edward Chancellor at the Goehring and Rozencwajg Investor Day. The chart and phases of the capital spending cycle presented at the conference were sourced from Marathon Asset Management.

From this vantage point, it appears that it's still early days for the AI capital investment cycle. The demand to get access to chips for generative AI applications remains robust and profit growth, judging from NVIDIA's results, remains eye-watering. It appears the cycle sits somewhere between late Phase One and early Phase Two. Ultimately, what will determine the longevity of the cycle is whether visible signs of returns on investment result from the money spent on AI chips and accompanying accoutrements. So far, there is little in the way of profits being generated from the transformational stories heard from myriad applications of generative AI.

A quick check of earnings for the 11 sectors of the S&P 1500 Index reveals that only the Technology and Health Care segments have expected profit curves that show a noticeable upward bend. Profits in the tech sector, ground zero for AI capital spending, makes sense. In health care, rising profits is no doubt a bullish call on an aging population. The remaining nine sectors show little hint of the systemic transformation AI promises to deliver (Exhibit D). Eventually, investors will have a "Jerry Maguire Moment," where they demand to be shown the money (Phase Three). If the returns on considerable investment fail to materialize, then it's on to Phase Four.

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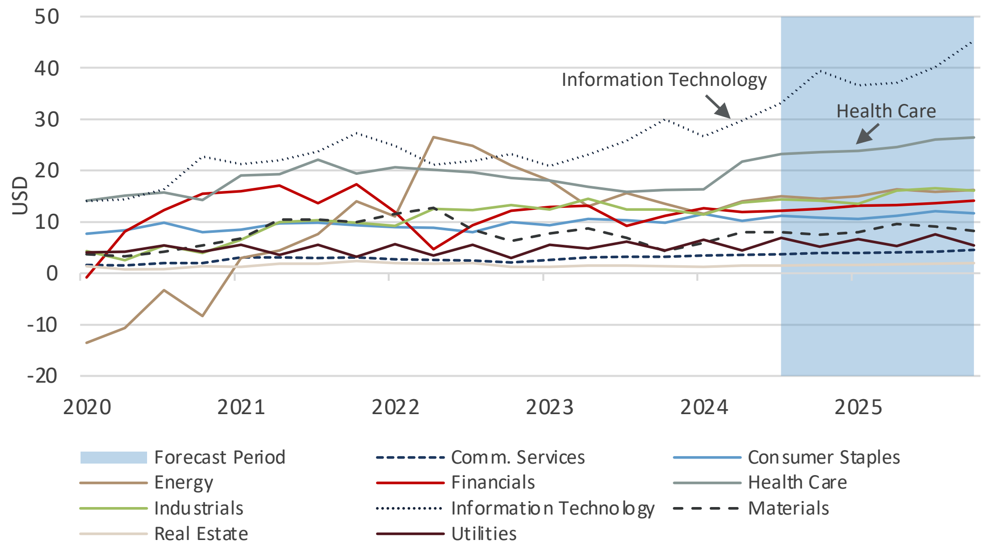
Exhibit D: S&P 1500 Composite Index Earnings per Share



Source: Macrobond, Fiduciary Trust Company. Data as of June 28, 2024.

Beyond NVIDIA and AI

Aside from developments in the stock market, a frequent question we are asked relates to the presidential election and its portent for the markets. In our 2024 Outlook, we asserted that recessions during a year in which there is an election for president are exceedingly rare. As noted above, the economy remains in good form. However, next year will require difficult decisions to be taken. Recently, the Congressional Budget Office revised its forecast for the budget deficit this year, increasing the gap between taxes and spending to $1.9 trillion, up from $1.4 trillion. The 36% jump is ascribed to higher interest costs, foreign aid, and other spending. The 64-page report is sobering. Large deficits for years to come will drive debt held by the public to 122% of GDP, an all-time high.[11]

[11] Congressional Budget Office, *An Update to the Budget and Economic Outlook: 2024 to 2034*. June 18, 2024.

This rising tide of debt could be exacerbated if the 2017 tax cuts are extended. These cuts, if continued, would need to be funded somehow. If past is prologue, it means more debt.

To the alarm of many, neither candidate shows any willingness to address the fiscal sustainability of government and the need to come to terms with the ballooning Federal debt. It appears that achieving a modicum of sustainable spending is the new third rail of politics. Afterall, fiscal probity is not a vote-getter, which means any talk of it is to be assiduously avoided. Markets will take a different view; already there are grumblings amongst keen-eye investors about how spending will be forced to correct.

Looking Forward

For the most part, the election will have little to offer investors other than spectacle. On the numbers, the economy is set to continue expanding and with it, earnings. Valuations will mean little with a zeitgeist that is all about growth. Sure, the refrain goes, "valuations are high, but profits are growing" Inflation will most likely remain anchored around three percent, which makes it difficult for the central bank to lower interest rates in step with market expectations. A market buckle that brings with it a 10% drawdown in stock prices is a real possibility in the run-up to the election or shortly thereafter. Consequently, we continue to hold cash reserves and short-duration fixed income to take advantage of any durable pullbacks that develop. ■

Exhibit E: Fiduciary Trust Asset Class Perspectives

	Asset Class	Attractiveness: Less	Attractiveness: Neutral	Attractiveness: More	Key Thoughts
Equities	**U.S. Large & Mid Cap**			○	• While the S&P 500 Index rose during the quarter, mid-sized companies as well as the average large company share fell • Despite the bifurcated performance, profits are expected to grow for the average stock as well as mid-sized companies • Presidential election years tend to be positive for equites; however, developing chaos in this year's contest could be disruptive
Equities	**U.S. Small Cap**		○		• Small cap indices fell during the quarter. This market segment continues to lag its mid and large cap brethren this year as well as the last one-, two-, three- and five-year periods • Theoretically, a soft-landing scenario is ideal for this sector as growth and lower interest rates make investing in small company equities attractive; however, this market segment struggles to secure durable sponsorship • This space is ideal for active management
Equities	**International Developed**	○			• First quarter returns in European and Japanese markets lagged the U.S. market • Attractive valuations, higher dividend yields, and quality global companies should make these markets appealing • A strong dollar hinders returns for investors in these markets
Equities	**Emerging Markets**	○			• Broad emerging market exposure is hindered by the importance of China. Investors remain focused on U.S. markets • Conditions might improve for these markets in 2024 if interest rate cuts in the U.S. unfold as expected • Active management is ideal for this segment
Fixed Income	**Investment Grade Corporate Debt/ Municipal Debt**	○			• Returns remain generally challenged due to the failure of interest rates cuts to unfold as expected. Long duration assets continue to show losses while high quality short duration issues perform relatively well • Keep duration at benchmark or less to reflect the market pricing of the timing and number of cuts the Fed is signaling
Fixed Income	**Structured Credit**			○	• Residential and commercial mortgages offer attractive risk-adjusted returns as do asset-backed securities • Seasoned mortgage-backed securities with low duration, significant credit support, and low loan-to-values offer an attractive opportunity for total return • Falling mortgage rates under a soft-landing scenario will help reignite the housing prices
Fixed Income	**U.S. High Yield**	○			• A soft-landing scenario is a positive for high-yield bonds - leverage and interest coverage are not at cycle peaks • Option-adjusted yields do not reflect a material economic slowdown, but spreads fully reflect the state of play • Active management is ideal for this segment of the market
Alts	**Private Assets**		○		• Select opportunities continue in the private asset arena • We are interested in niche opportunities where less capital is deployed • Private asset markets are going through a difficult reset period as new capital and portfolio exits are difficult. This represents an ideal environment for fresh capital to assess new opportunities
Cash	**Cash**		○		• Real returns on cash are an attractive alternative to near-term market risk • Battle to arrest inflation will make higher short-term rates prevail for longer than the consensus believes • Helpful portfolio buffer to volatile markets

Note: These forward-looking statements are as of July 1, 2024, and based on judgements and assumptions that change over time.

Donating Illiquid Assets to Donor-Advised Funds *(continued from page one)*

- Examples of complex assets that may be contributed to a DAF include restricted stock, real estate, cryptocurrency, hedge fund interests, and private company stock. It is worth noting that most public charities are unequipped or unable to accept these types of complex assets directly.
- Donors are not taxed on capital gains for contributed assets and typically receive a federal income tax deduction of up to 30% of adjusted gross income for contributions. Unused deductions can be carried forward and used for up to five years.
- Contributions of illiquid assets to donor-advised funds generally receive more favorable tax treatment than gifts to private foundations.
- While gifting can be a straightforward process with the right partner, such as Fiduciary Trust Company, it is important to follow specific gifting and substantiation rules to ensure maximum tax deductibility.

What Types of Assets Can Be Contributed?

Donors may contribute a wide range of assets to a donor-advised fund that has a program and expertise to accept them. Examples include:

- **Private Business Interests:** Private company stock and other ownership interests in privately owned or closely held businesses
- **Real Estate:** Residential, commercial, farmland, timber, and other types of real property
- **Restricted Public Company Stock:** Shares owned by individuals, such as key insiders, that are restricted by the company for sale for a period of time
- **Private Funds:** Hedge funds, private equity, venture capital, and other types of investment limited partnerships, and other fund types
- **Life Insurance:** Cash value policies which are typically fully funded
- **Cryptocurrency:** Bitcoin, Ethereum, and other cryptocurrencies
- **Tangible Personal Property:** Paintings, sculptures, jewelry, collectibles, rare item collections
- **Other Illiquid Assets:** Donors have contributed a wide range of other assets to donor-advised funds, even items as specialized as railroad cars

What Are the Benefits of Contributing Illiquid Assets?

There are four key benefits that donors often seek when gifting complex, illiquid assets to charity:

1. Increase the funds available to benefit charitable causes
2. Obtain an income tax deduction (subject to adjusted gross income limits) based on the gift's fair market value for most assets, provided the donor owned the asset for more than a year. Also, donors are not taxed on capital gains when an asset is sold in the DAF.
3. Rebalance the donor's investment and/or asset portfolio without triggering taxable gains
4. Offload responsibility for the sale of an asset

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What Are Key Considerations?

It is important to work with advisors who are knowledgeable in the logistics and tax implications of donating these gift types to charity. Although considerations will vary depending on the nature of the gift, some key factors that donors should keep in mind include:

- Generally, donors should consider contributing assets with a low cost basis that have been held for at least one year.
- The asset cannot be close to being sold or the IRS may consider it a "pre-arranged sale," in which case the donor may be liable for a taxable gain upon the sale.
- The DAF sponsor must complete appropriate due diligence to determine whether it will accept the gift. Also, any controlling organization, such as a hedge fund manager, must be willing to transfer ownership to the DAF sponsor.
- For assets that are intended to be sold soon after receipt by the DAF sponsor (which is usually the case), there must be a concrete plan for marketability and sale.
- The donor is responsible for obtaining a qualified appraisal and filing appropriate IRS forms (including Form 8283). The appraisal must occur within 60 days of the effective date of the gift and must be received by the donor before the due date of the federal tax return on which the charitable deduction is claimed.
- The donor may not continue to use or benefit from the property once it has been donated.
- Although the charitable deduction for art, collectibles, and other tangible property is based on the lower of cost basis or fair market value when contributed to a DAF, a larger deduction may be available if these items are gifted to a public charity that can use the asset in its normal operations for its tax-exempt purpose (for example, gifting artwork to a fine art museum).
- The charitable deductions for property created by the donor and life insurance policies are also limited to cost basis.
- Donations of partial interests in assets or restricted assets may receive a valuation discount for tax deduction purposes.

How Can Fiduciary Trust Help?

Fiduciary has been helping clients achieve their philanthropic goals through a variety of charitable giving strategies for over a century. We also partner with a network of experts to help you benefit from specialized knowledge when contributing illiquid assets. We are honored to have been recognized with multiple industry awards for our services, including the Best Philanthropic Offering Award by WealthBriefing. Reach out to discuss how we can help you achieve your charitable goals. ■