Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

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Investment Newsletter – April 2005

The Berkeley Investment Advisors' Long Term Income Portfolio

In my January 2005 newsletter, "Introducing Separately Managed Accounts: Investing in Securities", I explained in general terms the strategies I've used to consistently beat the market over the last 6 years. I briefly introduced clients to four risk tailored portfolios. This newsletter is the 3rd of a series in which I explain details about construction of the four risk profile portfolios. I will provide example trades that would be used for this portfolio.

A word of caution. My trading history may not be viewed as a guarantee that my future trading will produce similar results.

This portfolio is meant for clients who have a longer term investing horizon but still need to keep risk low. The objective is to collect relatively safe 4 - 7% returns in the form of interest and dividends on securities expected to have relatively stable value over the long term. This portfolio will invest in exchange traded funds (ETFs) where the underlying securities are medium or long term (> 5 year maturity) bonds, fixed and variable rate preferred stock, and mortgage Real Estate Investment Trusts (REITs). The ETFs provide greater liquidity than preferred stocks and diversification benefits but will come with lower returns. A mortgage REIT is essentially a portfolio of either residential or commercial mortgages. These mortgages may be floating or fixed rate mortgages depending on the particular REIT. The REITs will provide good liquidity and high returns but will likely fluctuate in price more than the other two types of securities. They also provide more upside since the dividend rates may increase as their holdings grow.

The preferred stocks must meet the following criteria:

1. Small or no premium versus the price at which the security could be called by the issuer.
2. Company has an investment grade rating from at least one of the major rating companies.

3. Dividends taxable at 15% rate.

We will limit positions in any one preferred to one day's average trading volume.

The value of the portfolio will fluctuate with changes in credit market conditions and general interest rate levels. In periods where rates are expected to rise (like now), the portfolio may become more concentrated on mortgage REITs and floating rate preferred stocks as a defensive measure and/or we may recommend limiting investment in the portfolio. For larger client accounts (over $5 million) we may use derivatives to hedge against rising rates.

Example Trades to Illustrate Trading Strategies and Results

Given my personal return goals and risk tolerance, I have not followed such a low risk strategy in the past. I have, however, purchased undervalued bonds and mortgage REIT's and then held them in portfolio even after their prices had risen to a point where future expected returns were in line with the goal of this portfolio.[1] Examples mentioned in previous newsletters are Russian bonds and Thornburg Mortgage. The first two examples I will give here are therefore not trades I have actually executed; they are positions chosen from current possibilities to illustrate the preferred stock strategy of this portfolio.

My first example is Freddie Mac preferred series M. (Freddie Mac is one of the quasi government agencies that guarantee residential mortgages). This is a variable rate preferred, whose dividend rate resets every 2 years at the then current 2 year Treasury bond rate[2] plus .1%. Unlike a treasury bond, the dividends are taxed at the 15% rate. This stock has a par value of $50 per share. At April 29th it closed at $42.10 per share. The dividend rate reset on 3/31/05 to $1.95 annually, a current yield of 4.68%. Freddie Mac is rated AA- by S&P.

As an example of a fixed rate preferred, I like Partner Re series C 6.75%. It has a par value of $25 and closed at 25.41 on April 29th. It is callable in May 2008. Its current yield is 6.64% and it qualifies for the 15% tax rate. This company is an offshore reinsurance company rated BBB+. I follow the insurance industry and despite recent scandals, I feel that the business fundamentals are sound.

Thornburg Mortgage is my favorite example of a mortgage REIT for the Long Term Income portfolio. At one time this was so cheap it fit my strategy for the Long Term Value portfolio. Now its growth has slowed down and price appreciated to a point where it is more appropriate for the income portfolio. This company currently trades at $29.96 and the annual dividend is $2.72, 9.08% annually. This company is in the business of originating and holding

[1] My reason for holding, even after the price increase reduced the yield, was avoidance of capital gains taxes.
[2] Technically it is reset to an index yield called 2 year Constant Maturity Treasury.

adjustable rate (residential) mortgages. They operate in the same markets as big banks but are a much more cost efficient player. In a rising rate environment, their originations may slow but so will mortgage prepayments. This company still has a relatively small market share and, given the competitive advantages of its business model, should have no trouble maintaining its current level of assets, income, and dividends - even in a shrinking origination market. While I expect some volatility in the stock price as rates rise, over the long run the steady dividend in difficult environments combined with the ability to grow the dividend in favorable economic environments, will support the current valuation.

Conclusion

The Long Term Income portfolio offers conservative investors the potential for enhanced fixed income returns relative to Treasury bond investing. In the current environment, the portfolio is positioned to preserve value in the face of rising long term interest rates while still providing superior after tax yield compared to a long term bond portfolio of comparable credit quality.

If you want to see details of all the portfolios and logistics in one document, you can request a brochure which covers all the details of investing in our separately managed accounts.

Market Notes

The Long Term Value Portfolio has a heavy concentration of energy stocks and has suffered losses as these stocks pulled back along with oil. The stock market consensus is that energy prices will come back down and therefore energy stocks are priced as if the long run price of oil will be in the mid $30's. So, even though the spot oil price hovers around $50, any move down reinforces the market's perception that it will retreat all the way down to $35 or below. This persists in spite of oil futures prices at $48 or better all the way out to December 2011. Right now the Saudis still have excess capacity and they are helping their customers build inventories. These inventories will be drawn down later as demand exceeds supply and prices push higher. This inventory build is a short term phenomenon and will have no impact on prices in the long run. The fact is that demand is growing faster than supply and prices will need to stay high or go higher to maintain a balance once excess capacity is used up. Although today's prices should cause increased exploration, most companies have decided to stand pat with existing exploration budgets. As time passes and the demand - supply dynamics keep prices high, energy company cash flow will persistently exceed the market's current projections. The bottom line is that the stock market drop means higher returns going forward - making it an even better time to buy.

William Lyon Homes, a holding in the Long Term Value portfolio, jumped 17.5% to $88.40 this week after the controlling shareholder (the CEO) offered to buy out minority shareholders for $82 per share. This company had *4th quarter* earnings per share of $8.58. In my opinion (and apparently many others') the offer looks to be far below the firm's true value. Several lawsuits challenging the low offer price have already been filed and the market expects a much higher price to prevail. I don't know if the CEO can afford to pay much more, but his announcement is the catalyst this stock needed to start moving up. The company is so small that no analysts follow it. Up until now, the stock has languished because of the lack of attention. I will be paying close attention to developments but I'm reluctant to sell at 10 times one quarter's earnings.

Commercial Metals dropped 25% since April 12th because of weak demand reported by other steel producers. The company now trades at less than 7 times earnings despite their announcement that they do not see any significant softening of demand for their products. I have added this company to the special situations portfolio because I think the market over reacted to news that is not entirely relevant to the company. I believe the price will correct (i.e. move back up) once a couple of quarters of sustained earnings reveal the strength of demand for the company's products.

Palatin technologies is down 28% in 6 weeks on no news. This thinly traded small capitalization stock seems to be suffering from a large institution exiting its position. Given that this company's major money making products are far from commercial launch, I don't expect any catalyst to emerge in the near term to drive this back up. Still, the potential returns are large relative to risks and good news could come at any time and take away the bargain price. I will be adding to the positions to take advantage of the institutional selling.

My longtime favorite Cemex also went on sale at the end of last week. While we didn't get it at the bottom on Monday morning, we did capture a couple of percentage points of the bounce. This stock trades in cycles and seems to be moving to an uptrend.

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