Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

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Investment Newsletter – July 2005

Investing in Fundamental Trends

This month I want to talk about the trends that I think are going to be important to investors for the foreseeable future. In looking at what has happened to prices relative to fundamentals in the U.S. residential housing markets, I have become dissatisfied with the overall risk versus return profile of the markets. While I still believe there will always be opportunities, such as New Mexico single family homes,[1] it is getting more and more difficult to find these opportunities. The world is constantly changing and in order to be useful to our clients, we must constantly look forward to the next opportunity – even if that sometimes means a change in focus.

The Impact of China

Last week China announced a change in their exchange rate policy. The Chinese currency is no longer pegged to the dollar. They revalued the Yuan upwards by 2% against the dollar and said its value will be managed with reference to a basket of currencies rather than just the dollar. While the 2% is meaningless in itself, the uncoupling of the Yuan from the dollar is a major event. So long as China was committed to a fixed exchange rate they were effectively forced to support the value of the dollar by investing their huge trade surplus in U.S. Treasury bonds. This has kept the dollar strong and interest rates low in the U.S. The change in Chinese monetary policy will mean a weaker dollar and higher interest rates in the U.S. Over time, higher rates will tend to reduce the appreciation of real estate in the U.S.

The next step for China will be to allow its companies and citizens more freedom to invest outside China so as to decentralize the country's investment of its capital surplus. It is very likely that a substantial portion of this new outbound investment will go into foreign real estate. A large chunk may go to

[1] We will, of course, continue to search out and find the best deals possible for our clients regardless of geographic or property type restrictions.

the U.S. Nearby countries such as Thailand will also benefit from small business owners buying vacation homes. Given the size of the expected Chinese capital flows relative to the very limited supply of available vacation property nearby, I expect big profit opportunities for those brave enough to invest in real estate outside the U.S.

China's vast supply of cheap labor and its entry into the World Trade Organization is causing a worldwide shift of labor intensive production to China. There are huge profits to be made from this shift and I expect the U.S. to reap big benefits as the realignment boosts U.S. productivity and our superior financial sector works its magic. Yes, I expect a substantial portion of the profits from this shift to flow to U.S. investors – including real estate investors. For example, sooner or later someone will figure out how to mass produce housing in China for export and assembly in the U.S. When this happens, the first[2] to benefit will be the developers who will enjoy a massive cost reduction even while house prices remain high. Later (this will take years) as the new lower cost structure permeates the industry, land prices will be bid up so that much of the excess profits will end up with the land owners.

The Impact of the Coming Wave of Retirees

Although, I've written on this subject before, I want to expand on my observations in terms of both domestic and international implications. The U.S. housing market statistics already show that 13% of home purchases are 2nd homes intended for vacation and/or retirement use. Overall this trend should continue and will tend to push up land and house values in desirable retirement areas like the Southwest, Florida, and Hawaii. Investors can make good money in these markets if they are careful to buy something that can carry itself for the long term without too much negative cash flow nor too much equity. This means avoiding overpriced markets and making sure there are renters if you are buying a house or Condo. In markets where renters are scarce, consider investing in undeveloped land to reduce holding costs relative to appreciation potential.

Japan and the West European countries will have an even higher percentage of the population retiring in the next 15 years than the U.S. These countries are much smaller than the U.S. and less endowed with warm weather retirement enclaves. I expect the wave of Japanese and European retirees to spend significant sums of money outside their home countries. Much of this will be on visits to vacation destinations, but a substantial portion will go into 2nd homes overseas. The Japanese will favor Hawaii, Thailand, and, to a lesser extent, Australia and New Zealand. I expect the Europeans to shop for bargains

[2] Actually the U.S. investors backing the new production process will share in the initial gains.

in Southeast Asia (Thailand again) and Latin America. Given the prominence of Hawaii and Thailand in my thinking, I am likely to make each of these the focus of future Newsletters.

The other trend I've noticed lately (particularly among retirees) is the popularity of management free real estate. By this I mean triple-net leased property (see the March 2003 newsletter for a detailed description). The twist is that investors are venturing beyond the traditional retail-commercial triple-net leased property into what is best described as master-leased residential property. This means that the sponsor of the deal leases the residential property long-term from investors on attractive terms[3] so that the investor has no management worries. The trade off is slightly lower returns. For most, the amount given up in returns is more than justified by the reduction in operating risks. This is the wave of the future and will provide investors a convenient way to combine their capital with savvy real estate management. This is a business that fits naturally with our mission at Berkeley Investment Advisors and I expect we will offer such opportunities in the not too distant future.

Hotel Condos and Land

So where does all this lead? Besides buying houses and apartments in the areas where we see capital flowing into, Hotel Condos and entitled land look like winning bets in retiree destinations.

While I still see land as a higher risk investment than the types of properties we generally recommend, I think the coming cost reduction windfall for developers significantly reduces the risk of entitled residential land. By entitled, I mean that the owner is entitled, under local law, to build specific building types on the land. Land investments will produce negative cash flow over the holding period and therefore should always be balanced with positive cash flow investments. The advantage of having a portion of your portfolio in land is that it is a more leveraged bet on local appreciation yet may be less risky in an area with a weak rental market.

Donald Trump essentially invented the Hotel Condo and this idea makes a lot of sense under certain circumstances. The basic idea is that you buy a hotel room and pay a management fee to have the hotel operator rent it out and maintain it for you. This could also be structured as a master lease whereby the operator leases the Condo long term and takes all operating risks. Effectively this is a way to allow smaller investors to participate in the institutional real estate market while enjoying the tax benefits of direct ownership. If you buy a Hotel Condo in an area that becomes popular with retirees (or newly rich

[3] I consider anything more than a 6.5% capitalization rate (gross yield) to be very attractive for small residential properties (assuming reasonable increases every few years).

Chinese) you can earn substantial returns without dealing with any of the management details. Because of their steady cash flows, these are less risky than raw land purchases and yet retain significant upside if you can get in at a reasonable price. There is already a thriving market for these in Hawaii and I expect the idea to spread to Asia in the near future.

Conclusion

As capital chases returns in the real estate market we must constantly reevaluate our strategies for finding opportunities. Looking at the major trends in the U.S. and world economy leads us to conclude that some of the best real estate investments going forward will be in areas popular with retirees and vacationers. Entitled land and Hotel Condos seem to offer some of the best risk versus reward trade offs in the market today. As with all real estate, finding the best deals requires research and expert help. Berkeley Investment Advisors urges you to work with us to find the right property for your situation.

Stock Market Notes

The run up in the portfolio has been nothing short of spectacular lately. At this point the Long Term Value portfolio is up roughly 14% since inception (3/15/05) versus a gain of 3.7% for the S&P 500. I hate to admit it, but overall client returns were held down by the large cash position that is waiting for special opportunities to arise. I don't want to wish for some major disrupting event, but when one comes, we will be ready to boost returns even further. At this point I want to urge any of you with substantial IRA money to take a look at your returns and ask yourself if you wouldn't be better off with active management by Berkeley Investment Advisors.

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