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Investment Newsletter – June 2015

This newsletter starts with look at factors impacting our taxable fixed income strategies over the last 12 months. Next is an update of the performance of the Long Term Value strategy for the last 10 years. Finally we review the current market environment, starting with what I consider the principal cause of global economic difficulties – poor government investment policies in China.

Flat Returns in Fixed Income Strategies

Normally I update each strategy once per year, but this month a client asked for a comment on the relatively flat performance of the Short Term Income and Long Term Income strategies over the last year. Over the last year the return for Short Term Income was -2.41% and the return for Long Term Income was -4.04%. Both strategies were running at break-even until this month. Overall it was not a good year for bonds; the comparable short term fixed income ETF (ticker BSV) returned 1.22% and the long term bond ETF (ticker AGG) returned 1.81%.

Both of these strategies invest in a variety of different underlying fixed income securities via both exchange traded funds (ETFs) and closed-end fund (CEFs). Both portfolios are more than 80% in CEFs and these are responsible for most of the difference in our returns compared to the overall bond market.

In order to understand these funds, the first step is an explanation of the securities they hold – fixed and floating rate bonds and loans. Prices and yields move inversely – when a bond's yield is rising, its price is dropping and vice versa. The amount of price change (sensitivity) for a given change in yield is called duration. This is related to the time frame over which an investor will receive cash flows corresponding to the price of the bond. If the yield rises by 1% on a bond with a 5 year duration, the bond's price would decrease by 5%.

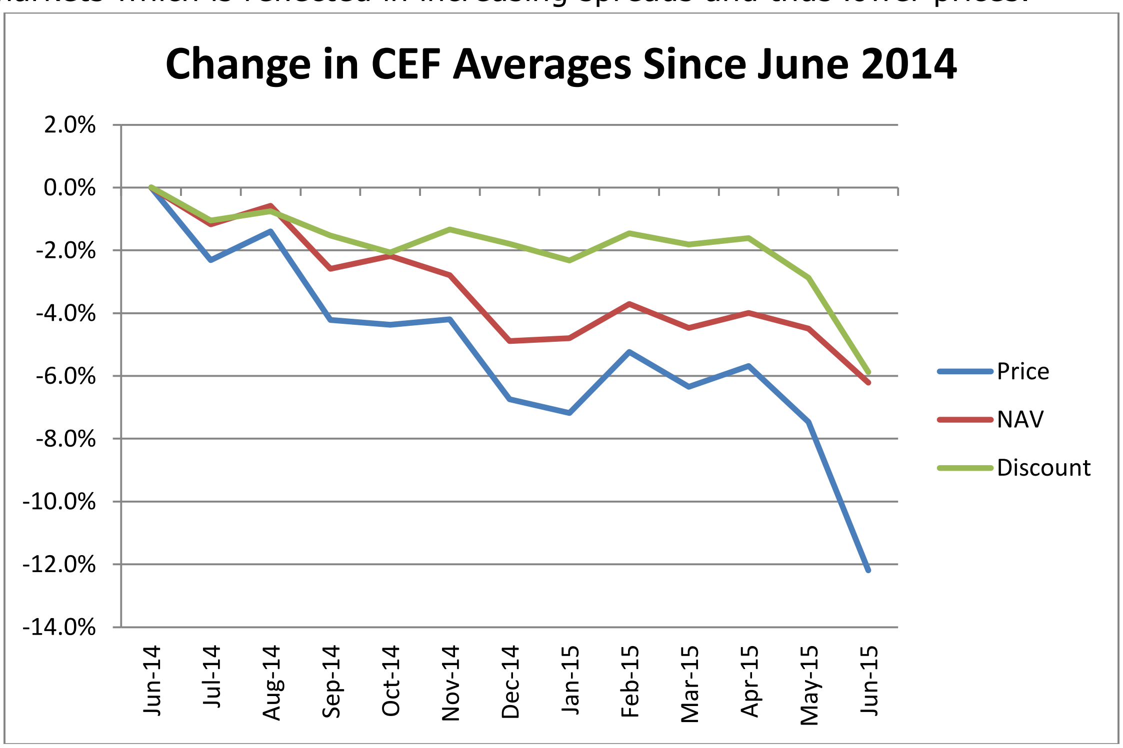
The bonds underlying our positions are primarily below investment grade; their risks and returns relate to both the default free interest rate on government bonds of similar maturity, and the additional yield spread that compensates investors for the default credit risk of the corporate borrowers. The Long Term Income portfolio has duration of about 4.5. Because the rates on securities in the Short Term Income portfolio reset frequently, it has a duration of 1.4 with respect to default free interest rates. With regard to changes in credit spreads, however, it is more sensitive: its duration relative to credit spreads is roughly 3.25.

Given the background above, we can look at how various factors impacted performance of our portfolios. Over the 12 months ended 6/29/2015, the 5 year U.S. treasury yield has not changed. Over the same period, data from the Federal Reserve on high yield bond spreads shows that these increased by 1.38%. Applying the above duration measures, we expect this market-wide spread increase to reduce high yield bond prices by about 6.2% for the Long Term Income portfolio and by about 4.5% for the Short Term Income portfolio.

Besides interest rates and credit spreads, our returns are impacted by changes in CEF prices relative to the underlying bonds. To determine what impact this had, I downloaded monthly prices and net asset values (NAVs) for five of our largest CEF holdings from last year. NAV represents the value of underlying bonds inside the closed end funds and the difference between price and NAV is the discount that funds trade at relative to value. The chart below provides information on the relative impacts of underlying bond price declines and the widening of CEF discounts (from NAV). Specifically the chart below shows cumulative changes as a percentage over the 12 months. Note that the depreciation in prices is partially offset by interest we received, thereby dampening return volatility – but not eliminating it. For the most part, interest payments have not declined by much - these lower prices imply higher yield going forward.

The chart shows the underlying down trend in NAV/bond prices (the red line in the middle). There are two primary factors pushing these bond prices lower:

1. The large drop in oil prices had a big impact on high yield bond prices - i.e. credit spreads widened because of the weakening of fundamentals for a large chunk of this market.
2. We are seeing a more general trend towards greater risk aversion in the bond markets which is reflected in increasing spreads and thus lower prices.



This also shows that the fund prices dropped almost twice as much as the underlying bond prices (NAVs). Discounts widened by about 5.9%. This reflects a retail investor base that tends to react (or over-react) to market news more strongly than institutional investors in both up and down markets. This, combined with the low trading volumes of the CEFs, causes our portfolio to experience more volatility in both directions. The flip side of this is that we get extra income from this liquidity effect over the complete cycle. The Long Term Income portfolio captured the upside version of this phenomenon in its 1st and 3rd years when it returned 19.8% and 23.1% respectively. The Short Term Income portfolio also had two double digit years: 10.3% in its 2nd year and 17.5% in its 5th year.

My expectation is that we will see oscillating interest rates within a range because whenever interest rates rise, their negative economic impact and the lack of capital investment opportunities will then pushes rates back down. These fluctuations in bonds are not surprising in this environment. My expectation remains that we can earn 6 - 7% per year over the long run on these positions.

Long Term Value Portfolio Strategy and Performance

Berkeley Investment Advisors uses several different strategy portfolios to manage client assets. The Long Term Value portfolio is an equity strategy. This portfolio is invested in exchange traded funds (ETFs), Real Estate Investment Trusts (REITs), stocks, and other equity securities. This portfolio is meant for clients with a long term investing horizon who are willing to take moderate risk in pursuit of equity market returns (i.e. higher than fixed income returns).

The objective for this strategy is to earn returns of at least 10% annually. Because the goal is an absolute level of return (to compensate for equity market risks) rather than a return relative to the market, this strategy's returns will deviate significantly from overall market returns. Over the long run, a disciplined return requirement that is in line with risks, should lead to better returns because we avoid big permanent losses that come from paying too much for stocks in speculative markets.

We focus on a relatively small number of holdings that offer the best expected long term returns given the risks of each stock. We use independent research providers to provide potential investment ideas. One such service is a screening tool that identifies companies with significant insider buying of their shares. We then review financial statements to assess value as compared to market price and invest only if we expect the stock to produce returns of at least 10% annually and the returns are in line with the risks for that stock.

Expectations of returns are a function of the company's future cash flows, the current market price we must pay for the stock, and an expectation of where the stock price should be in a valuation environment that is no better than average historically. Since long run valuation norms and cash flow projections change slowly, the current market price is the most important driver of changes in expected future returns. A simplified example will help illustrate the point.

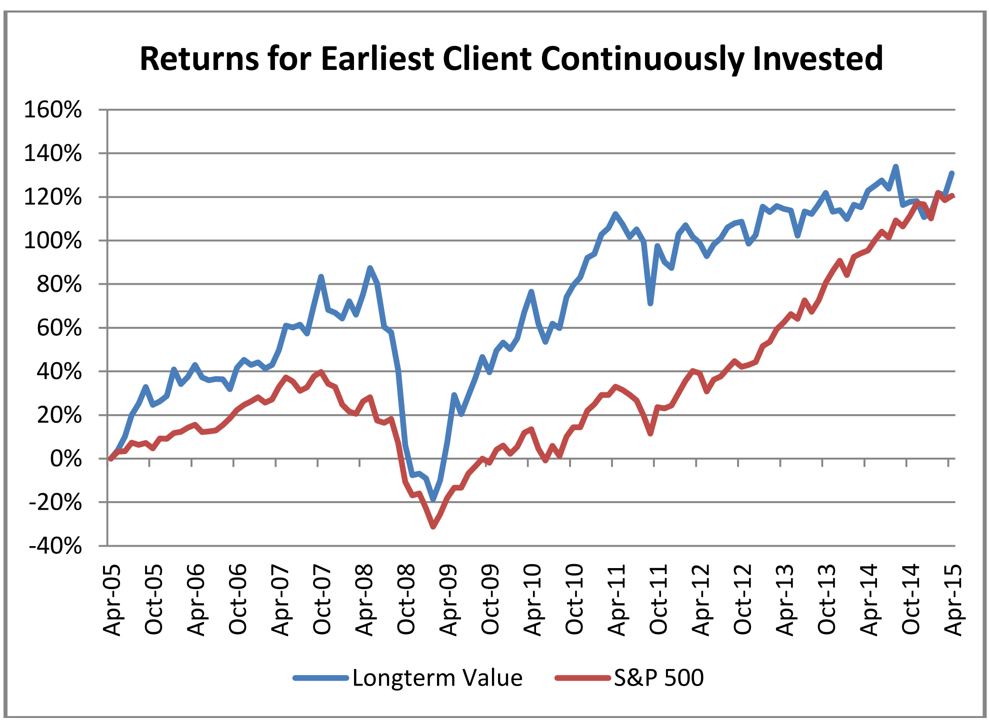
Let's assume that earnings and cash flows will grow at 6% annually and that the long run average of stock price divided by earnings (P/E) is 10[1]. Suppose the

[1] This is not the actual valuation measure we use but it keeps the example simple.

stock is earning $10 per share in the current year and paying out dividends of $4 per share. If the current price is 10 times earnings (equal to the long run norm), the stock price is $100 and the dividend as a percent of price is 4%. Because the stock is trading at its expected long run valuation multiple of 10, the stock price should appreciate at the rate of growth in cash flows – 6%. Total expected return will be this appreciation rate plus the dividend return of 4% = 10%. Now suppose the current price goes to $120 so that the P/E is now 12. Then we should expect appreciation to be less than 6% as the P/E moves back down to a normal level of 10. If the P/E multiple reverts to 10 in one year, the ending price would go to (earnings of $10*1.06) * P/E of 10 = 106. The price decline would be -$14. Adding back dividends of $4 gives total loss of -$10. Thus return was -8.3% (= -10/120). Conversely if price is below $100 (meaning P/E is less than normal) we'll get a return greater than 10%. For example: if the price is $90 today but the P/E goes back to 10 after one year, the return is (106 -90+4)/90 = 22.2%.

The illustration above explains the math for returns relative to valuations for a single year. In reality, reversions to long run norms can take a very long time. In the meantime our returns will deviate significantly from the long run expectations.

In order to calculate returns for the Long Term Value strategy we selected the client who has had money in this strategy the longest and analyzed their account in great detail. To correctly calculate returns we must properly account for all money going into or out of the strategy, including dividends and fees. The return calculations here cover the period from April 30, 2005 to April 30, 2015, a period of 10 years. Over that time, the Long Term Value portfolio produced a cumulative return of **130.8%** compared to a cumulative return of 120.6% for the S&P 500 exchange traded fund. This return is calculated net of the 1.25% annual fee paid by the client. **So the portfolio return exceeded the benchmark by 10.2%.** This works out to about .5% higher return annually over the period.



The chart above shows the path of returns. As you can see there is quite a lot of volatility in returns. Excess returns were very high just after the market crashed – this provided us lots of cheap stocks to buy. More recently our returns are low relative to the market as it approaches record valuation levels. At this point in the cycle our excess return is somewhat disappointing but I expect our advantage to widen again during the market's next major decline and even more so subsequently. Patience is a virtue in investing.

The Source of Worldwide Deflation: Bad Investments in China

China is showing signs of the stress of massive miss-allocation of capital that is likely to eventually lead to credit losses on a scale similar to the mortgage crisis in the U.S. A large part of this financial activity involved local governments borrowing to finance redundant industrial capacity and speculative real estate developments which are still empty or nearly empty. The lenders to the local government projects were mainly government controlled banks. So far the central government is working to hide the problems and avoid defaults. The latest move is a reduction in interest rates on local government borrowings instituted via a nationwide exchange of bonds for loans. This will reduce accounting profits of the banks and will more closely reflect the reality that these debts will ultimately generate losses, not gains. China might well hide these problems for years to come just as Japan did when their bubble burst in the late 1980's. At an economy wide level it probably means China will continue to suppress domestic consumer demand and run large trade surpluses to replace the capital destroyed by these wasteful investments. Thus we can expect this imbalance of supply and demand to continue to depress the economies of China's trading partners.

Current Market Conditions and Expectations

In the current month high yield bond spreads continue to increase - they are up .33% since May. June has also seen a .13% increase in the 5 year treasury yield. As a result, our average fund NAV declined 1.8% for the month. More importantly we've seen CEF price discounts from NAV widen by another 3% just this month - to an average of 13.5%. Discounts haven't been this wide since 2008. This indicates an accelerating shift towards risk aversion in the fixed income markets – buyers are requiring significantly increased returns to step in and provide liquidity. It seems only a matter of time before this attitude shift shows itself in equity prices.

The overall stock market continues to trade at ever higher valuation multiples – i.e. the price to earnings ratio continues to expand. These levels correspond to very low long term future returns for stock index investors – and high risk. So far there has not been any catalyst to cause investors and traders to re-think the risk versus return trade off in current prices. Such a catalyst may now be close. The Fed is widely expected to raise interest rates in September. If other interest rates keep rising as they have, equities will look increasingly mispriced relative to fixed income. Another potential catalyst for a re-thinking of risks is the likely exit of Greece from the Euro currency union.

The Greek government has defaulted on their debt and called a referendum (aimed at avoiding blame for the coming depression in Greece). A no vote surely means Greece will leave the Euro. But even if they do vote to accept the last bailout terms offered, it may be too late. The European Central Bank was lending money to Greek banks to keep them open during negotiations. Additional lending has stopped and Greek banks are closed until they find another source of money. This likely means Greece will have to issue its own currency (possibly as IOU's) in order to re-open the banks.

Whether or not interest rate increases or the Greek default become catalysts for stock declines, ultimately, I expect the market will re-price risks to a more rational level. Meanwhile, the rise in yields on our fixed income portfolios mean that we will earn higher returns going forward. The current yields and discounts on our fixed income strategies are very attractive given the deflationary environment. While we can expect decent returns in the equity positions we currently hold, we are likely to get much better opportunities in the next downturn.

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