Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

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Investment Newsletter – March 2005

The Berkeley Investment Advisors' Long Term Value 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 2nd of a series in which I explain details about construction of the four risk profile portfolios. I will also provide further background on the two trading strategies used for this portfolio, including example trades that contributed to my performance record.

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

The Long Term Value portfolio is meant for clients with a long term investing horizon who are willing to take moderate risk[1] in pursuit of equity market returns (i.e. higher than fixed income returns). The objective is to earn returns at, or above, those available in the general stock market but with less downside risk. This portfolio will invest in exchange traded funds (ETFs), Real Estate Investment Trusts (REITs), stocks, and other equity securities[2] based on the **Long Term Value** strategy and the **Under-appreciated Income and/or Growth** strategy. (The January 2005 newsletter has detailed strategy descriptions). ETFs will be used to target geographic regions or specific sectors of the economy expected to benefit from demographic and economic trends while providing diversification across individual stocks. Individual companies must have the management talent and business model to capture significant value from their sector and have a price to earnings (P/E) ratio[3] which should

[1] Meaning 12 month returns on this portfolio fluctuate less than returns on a broad based index fund.
[2] By other equity securities, I mean other legal structures available for public trading in the U.S. Examples include master limited partnerships (MLP's) and Canadian royalty trusts.
[3] Price to Funds From Operations (P/FFO) in the case of REITs.

allow for long run returns of at least 10% under reasonable income and cash flow growth assumptions.

This portfolio will fluctuate in value along with the general market but should have less downside risk than the general market because of the emphasis on dividend paying stocks and lower P/E stocks. The focus on certain sectors may occasionally lead to larger down moves than the market, but these moves will tend to reverse themselves over a long enough period (12 months).

Example Trades to Illustrate Trading Strategies and Results

I will start with a strategy I call Under-Appreciated Income and Growth. Companies that fit this strategy will tend to be smaller companies that are not well understood. We look for companies that have below market Price to Earnings (P/E) ratios and good prospects for continuing earnings growth - at least in line with inflation. Such companies are particularly attractive if a substantial portion of earnings are paid out as dividends.

My example company for Under-Appreciated Income and Growth is Thornburg Mortgage (NYSE: TMA). This company is in the business of originating and holding adjustable rate (residential) mortgages. They operate in the same markets as big banks but are a much more cost efficient player. This company is a Real Estate Investment Trust (REIT) and therefore must pay out 95% of its income as dividends. When I bought this company at $17 in November 2001, the yield on its stock was 12.9% and it had a record of continually increasing its income and dividends. This company is relatively small and is not widely followed so the market had not properly valued this stock's future cash flows. As its income and dividends have continually increased, the stock has risen to $28.96 as of December 31, 2004, giving it a total return in excess of 30% annually. At this point the yield has dropped to a more realistic level of 9.4%[4]. I think this is fairly valued now and I don't expect any price appreciation in the near term. Still, for a conservative investor, the 9.4% yield is a good return for such a low risk stock.

Now let's look at the Long Term Value strategy. Here we are looking for companies with reasonable valuations that will benefit from current and expected future market conditions. Low P/E companies that are in a position to grow earnings at least in line with inflation fit this strategy but we are also interested in certain companies with P/E ratios above market. If a company can increase earnings fast enough over a long enough period, it can increase the denominator (of P/E) relative to price and therefore reduce the P/E ratio closer to the market average. More specifically, we want to have high confidence that earnings will grow fast enough over a 3-5 year period to bring the P/E ratio

[4] The yield drops as the price goes up.

down even while the stock price is appreciating enough to give us our desired return.

Examples of Long Term Value strategy investments are Gables Residential (NYSE: GBP) and General Growth Properties (NYSE: GGP). Both of these are REITs and thus earnings are not the preferred measure of economic income[5]. Operating cash flow (also known as Funds From Operations) is the preferred metric. Notice that the inverse of P/E is earnings/price - which is referred to as earnings yield. In the case of REIT's, which must pay 95% of taxable income out as dividends, we can look at dividend yield as a proxy for (the inverse of) the P/E ratio. In this case, the higher the yield, the cheaper the REIT is, and the less growth in cash flows we need to achieve our required returns.

In May 1999 Gables Residential Trust was priced at $23.50 per share and was paying quarterly dividends of $.51 per share. Thus its dividend yield was 8.7%. This company's business model is the standard apartment owner business model and management had incentives in place that aligned their interests with the shareholders. I estimated that its cash flow, dividends, and therefore share price would grow by about 7% annually over the long run. I estimated a 10 year after-tax return of 10.6% per year and bought this REIT on that basis. Four years later, in May 2003 I sold the stock in my taxable account at $29.49 (and bought it in a retirement account). The compounded rate of return over that period, including dividends, was 15% pre-tax – roughly 10% on an after-tax basis. As it turned out, dividends only grew by 4.2% annually because in 2002-2003 low interest rates caused vacancy to increase as people bought houses. But the low rates made the existing dividend stream more attractive and so the stock price appreciated at an annual rate of 5.8% over this four year period. Since I moved the position to my retirement account[6] it has produced a pre-tax return of just over 20% per year.

In December 2003, General Growth Properties was priced at $27.30 per share and was paying quarterly dividends of $.30 per share. Thus its dividend yield was 4.4%. Although this yield is low for a REIT, the underlying cash flow (Funds From Operations) was running at $2.31 per share annually, giving lots of potential for dividend growth. This company is the second biggest owner of shopping malls in the U.S. and this real estate sector had great fundamentals (dropping vacancy, rising rents). Management of the company felt that the stock was undervalued and were using their own money to buy shares. This is a very positive signal and was the clincher that led me to buy the stock. As expected,

[5] Because real estate depreciation is not a true expense.
[6] Where it is no longer included in my return calculations.

Funds From Operations increased by 20% in 2004 and the dividend was increased by 20% in October 2004. The stock finished the year at $36.16 giving me a 37% return for the year. This month I sold this REIT after concluding that rising short term interest rates could reduce its operating cash flow (and I've found other opportunities that look more promising in the current market environment).

Conclusion

The Long Term Value portfolio offers patient investors the potential for market beating returns. The focus is on valuation and downside risk avoidance so as to match market returns while reducing the risk of loss relative to the market. For those investors who can tolerate a bit of additional risk I recommend a combination of the Long Term Value portfolio and the Special Situations portfolio (profiled in the February 2005 newsletter). 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.

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