Real Estate Brokerage/Retirement Planning

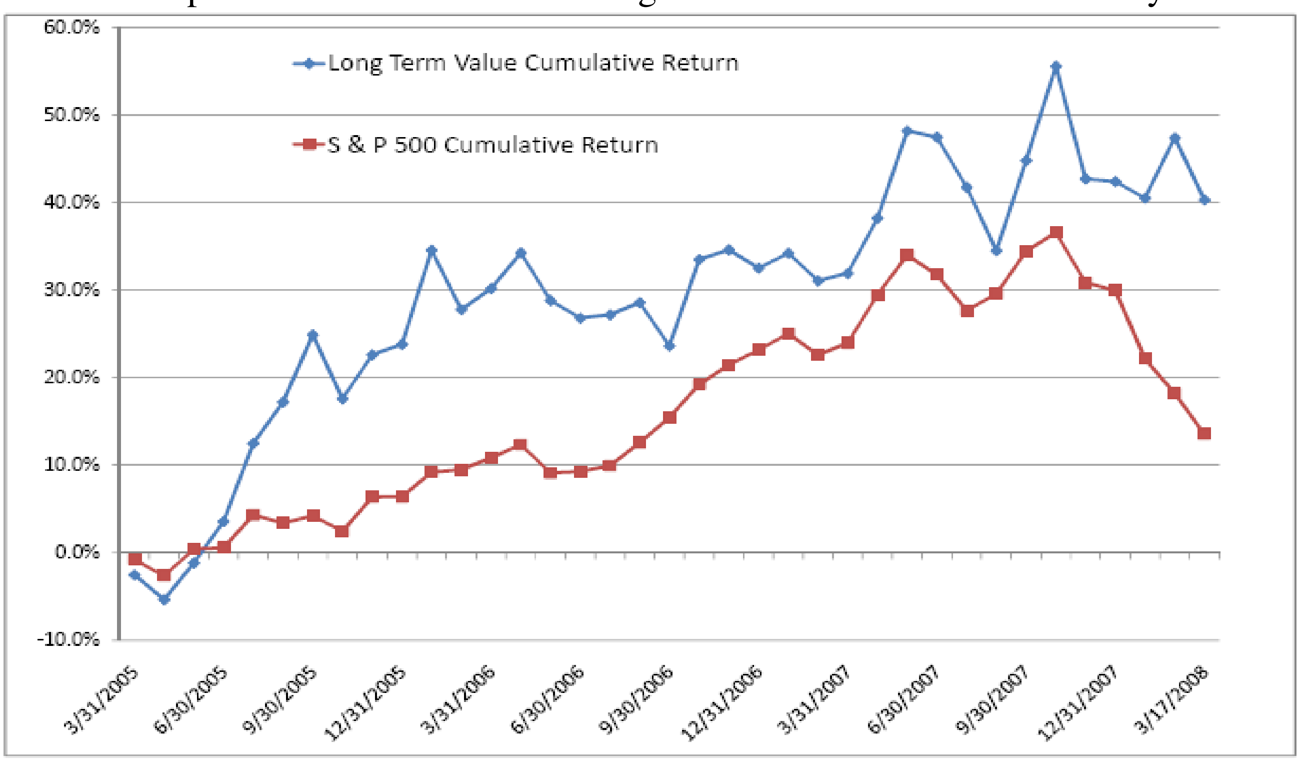
Licensed by the California Department of Corporations as an Investment Advisor

Investment Newsletter – March 2008

Long Term Value Portfolio 3rd Anniversary

March 17th marked the 3 year anniversary of managing client money in our main portfolio – Long Term Value. As the name implies, the strategies employed in the portfolio are meant to outperform the market when given enough time. I consider 3 years to be generally sufficient for this portfolio to outperform and so now is an appropriate time to have a look back to see how things turned out and explain the results. A long time frame is required because in shorter time frames, psychological factors in the market are strong relative to fundamental factors and thus these may overwhelm underlying economic results.

The graph below charts the performance of the Long Term Value portfolio since its inception on March 17th 2005 using client account data for the three years.



Over the three years ended March 17, 2008 the Long Term Value Portfolio had a cumulative return of 40.3% after fees. This equates to an annual compounded rate of 11.9%. The Standard & Poors 500 (S&P) index had a cumulative return over this period of 13.5%: an annualized return of 4.3%. Thus the Long Term Value Portfolio outperformed the S&P by a total of 26.8% over the three years, an annualized advantage of 7.6%. This is roughly in line with my expectations but significantly above what I told clients they should expect from this portfolio. Looking at the graph on the prior page, you can see that this portfolio is more volatile than the market. This is so because the portfolio is concentrated in relatively few stocks (about 30) and is focused on certain sectors - energy and foreign stocks most heavily.

The following table breaks down returns by calendar year.

Period	2005	2006	2007	2008	3 year total
S&P 500	6.4%	15.8%	5.5%	-12.6%	13.5%
LT Value	23.8%	7.0%	7.5%	-1.5	40.3%
Difference	17.4%	-8.8%	2.0%	11.1%	26.8%

The big gain in 2005 was driven by a correct prediction of rising energy prices and some good real estate picks. In 2006 the portfolio lagged the overall market significantly – energy prices stalled out for the year. A surprise Canadian tax increase on energy trusts also took a chunk out of returns that year. By contrast, 2007 saw further big gains in energy prices which helped the portfolio post strong returns but the impending recession induced by the credit market problems pulled our portfolio down along with the rest of the market in November and December. The result is that our energy positions were priced as if oil had already fallen.

In 2008, energy prices are in fact rising, not falling – this in spite of a U.S. recession which probably began in January. As a result, the portfolio has lost very little value while the S&P has plummeted more than 12%. This is consistent with my assertion that the portfolio's value investing focus reduces the risk of large declines in value over longer time frames. The 10% decline since the portfolio's value peak in October is within the range of my expectations. I do not expect another 10% drop in this portfolio though I do expect the overall market to drop further in 2008. Given the portfolio's 5.4% dividend yield, I expect that we can generate positive returns in 2008 even if our stock prices don't move; this should lead to much better results than the S&P 500 in a recessionary environment.

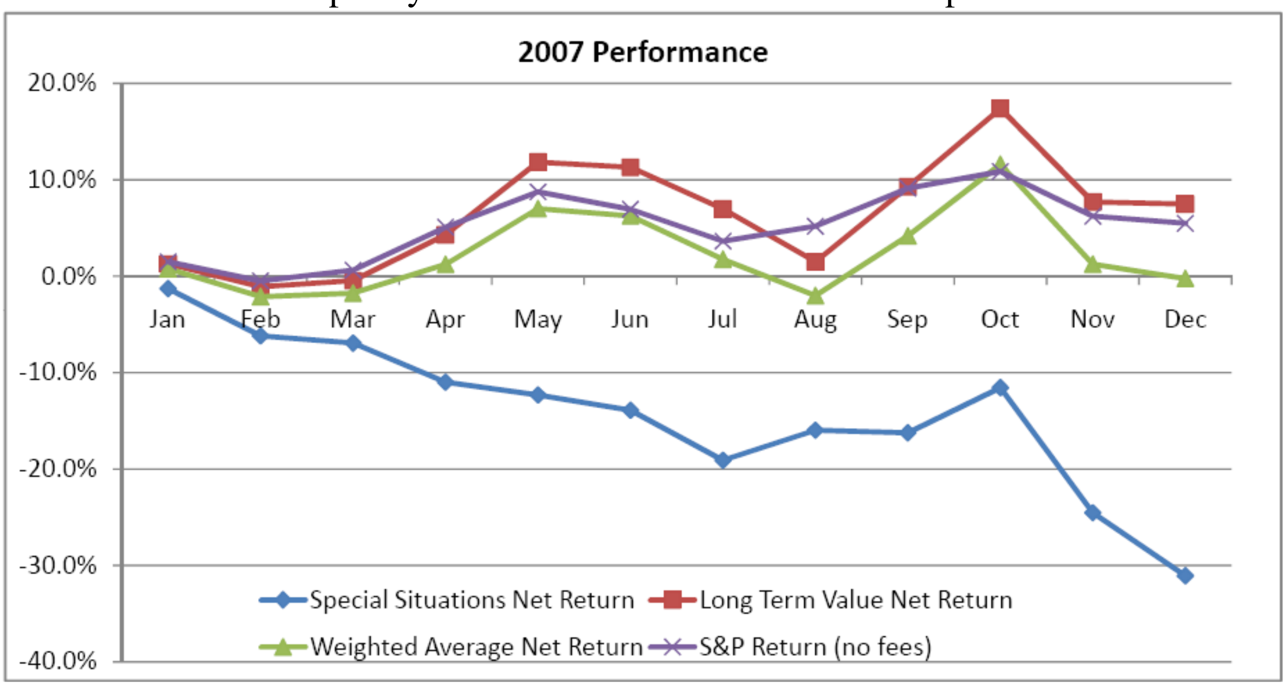
Long Term Value Portfolio 2008 Positioning

Although past results do not guarantee future returns, I am very active in positioning the portfolio to outperform the S&P (and Treasury Bills) in 2008. There is a significant risk of further major declines in the dollar and increases in inflation. In this environment, we want to remain in our high dividend energy positions. In addition we have started buying property REITs now that their valuations have come down to reasonable levels. Soon we will invest excess cash in mining stocks to further position the portfolio for inflation and dollar risks. In my opinion, these moves provide protection against some very significant risks to the economy.

Separately from the Long Term Value Portfolio, I have also set up hedging positions for my clients in order to earn offsetting gains when the overall market declines. This may cause us to underperform the market on an overall basis if the market goes up, but given the high likelihood of market declines, I believe this is the prudent thing to do in order to preserve capital.

2007 Combined Portfolios Performance Review

Besides the Long Term Value Portfolio, clients also had money allocated to the Special Situations portfolio in 2007. In 2006 this portfolio gained more than 60%. Unfortunately, 2007 was not a good year to be invested in this portfolio. The Special Situations portfolio declined 31% net of fees – thereby erasing most of the prior year gain. Based on the recommended beginning of year weighting of 80% in Long Term Value and 20% in Special Situations, and no intra-year rebalancing, a typical client would have had a combined net loss of .2% for 2007. This combined performance lagged the S&P 500 by more than 5% - see graph below. This is the first time in 9 years that my returns have failed to beat the S&P 500. It is a bitter disappointment for me to have such a poor year and I am determined to make up for this in 2008.



As the graph shows, overall performance was tied with the S&P 500 at the end of October but big losses in November and December brought us down to negative territory by year end. The Special Situations portfolio is primarily responsible for this poor performance. As I will explain, I have learned some valuable lessons from the mistakes made in 2007 with the Special Situations portfolio.

What Went Wrong in 2007?

The biggest mistake, by far, was buying a Prime mortgage lender without properly assessing its financial structure. This won't happen again!

Stocks often have a second leg downward after an initial drop. Given a strategy of buying as soon as the stock appears mispriced, it is not surprising that we took losses by being early into the mortgage REITs. What is surprising, however, is that the write downs of Sub-Prime mortgage securities has frozen almost the entire asset backed securities market and caused significant realized losses on unrelated credits - even when there is no real problem with the underlying borrowers on these securities. In our case, our mortgage REITs faced mark downs on investment grade commercial mortgages and residential mortgages indirectly guaranteed by the U.S. government. Eventually some REITs faced margin calls or refinancing problems that forced them to sell securities at prices much lower than their long run value. Unlike when we buy a stock cheap and wait for the market to bid it back up, short term loan repayments meant that the REITs could not hold for the recovery. In addition, one of our holdings must securitize student loans to generate earnings. They cannot make money until the market returns to normal.

The market disruption has become much more severe and lasted much longer than I first imagined it could. In the two prior major disruptions in which I traded (1998 and 2001) things were different. Then, plenty of risk capital came into the market seeking out undervalued securities that had lost value not because of fundamental changes but because of liquidity selling or fear. As a result, each time mispriced securities rebounded within 6 to 9 months. This time has been different. Expected Sub-Prime losses are much larger than the real economic losses of these prior episodes and therefore the financial system's risk taking capacity has been dramatically reduced. Compounding this (as I explained in my September 2007 newsletter) is the need for everyone to hold higher capital ratios. Each round of deleveraging via asset sales causes more mark downs and further capital destruction; this then leads to another round of selling. This deflationary spiral can only be stopped if sufficient new risk-taking capital comes into the market to make up for the capital lost in the prior round of selling. Although much new capital has come to the market from Asia and the Middle East, so far it has been too little to stop the cycle. Now fear is overwhelming investors.

This will require government capital to stop the spiral. The Bear Stearns rescue and the government's pressure on FNMA and FHLMC to raise capital and invest in mortgages, indicate that the government now understands what is needed. Still, significant action will require responsible legislation from Congress authorizing prudent investment in support of credit markets rather than miss-directed spending.

Although I am not optimistic about the government doing the right thing, I believe our portfolio is undervalued even without a proper policy response. If we get lucky and the Fed explains what is needed so that Congress acts, we will have tremendous upside.

What Have We Learned?

Companies with relatively large short term borrowings face significant liquidity risks which make them much riskier and harder to predict than stocks beaten down by contagion selling but without liquidity risks. In effect, market fears can become self-fulfilling with these companies: they may be forced to sell perfectly good assets at substantial losses or raise highly dilutive capital when their shares are down. We should always consider whether temporarily irrational markets can cause such companies to fail before deciding to take a position in them.

I also now realize that we committed far too much capital too early in the Special Situations portfolio. In the future I would not recommend that clients start with more than 10% allocated to this portfolio. That way, if a substantial loss occurs, it will be far easier to add more money to the portfolio and thereby average down the cost basis to improve the chances for making big gains. In the past, this has been my policy with my personal portfolio. I have doubled my positions when prices declined but I still expected recovery. This enabled me to breakeven well before my original buy price and go on to spectacular gains. But with 20% of capital invested initially, it would be imprudent (or at least uncomfortable) to increase the investment much further in the face of large losses.

Conclusion

Despite having taken some lumps over the short term from our Special Situations portfolio investments, Berkeley Investment Advisors has proven superior at long run investing. In particular, the Long Term Value Portfolio has achieved a remarkable record (40%) over its three years of existence. The markets are constantly changing and the lessons learned from recent conditions should serve to improve our risk management going forward and help us deliver even better results. I aim to vastly improve my clients' investment performance compared to indexing and help them achieve their financial goals sooner and with less risk than other alternatives. Market timing is futile, the best strategy is to pick a good money manager and stick it out through the downturns. The long run is what matters!

Contact Information

RayMeadows@BerkeleyInvestment.com San Francisco phone (510) 367-3280		Single Family Home Investment: RickRife@BerkeleyInvestment.com San Francisco phone (415) 425-3332