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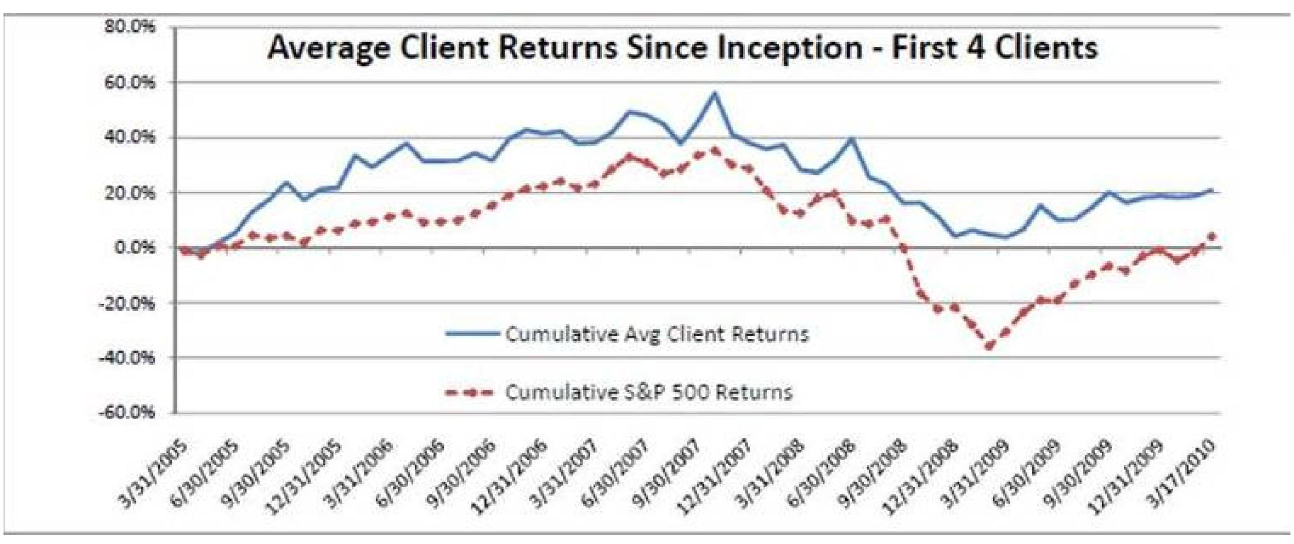
Investment Newsletter – March 2010

This month marks our fifth anniversary of managing client money in the stock market. This month we present our results, along with our assessment of current market conditions and the impact on investing strategy. In the announcements section we refer you to a recently published stock analysis we did on one of our holdings and we introduce a recent addition to our company.

Performance Review for 5 Years Ended 3/17/10 (Since Inception)

At Berkeley Investment Advisors, we implement our investment strategies in a number of different risk portfolios – into which we allocate client money according to their risk tolerance. Our primary equity portfolios are called Long Term Value (which hit its 5 year anniversary in March 2010) and the Special Situations portfolio which came just a bit later. In January 2008 we initiated what we call the Hedge portfolio which we use to reduce the risks of the first two strategies under adverse market conditions. At that time we also moved a portion of client funds into some income oriented portfolios so that this money would be available to reinvest in the Long Term Value portfolio once the risk of market wide losses is reduced to an acceptable level.

The chart below plots the cumulative returns for the overall blended portfolio recommendation (for the average of the first 4 clients) over the 5 years ended March 17, 2010 as compared to the S&P 500 index. These 1st four clients earned an average cumulative return of <u>20.9% compared to 4.1%</u> for the S&P 500 over the same period.



The following table breaks down returns by calendar year.

First 4 Clients Average Returns Over 1st 5 Years

Returns Comparison	From Mar 17					to Mar 17th	Cumulative Since
Year	2005	2006	2007	2008	2009	2010	Inception
Average of Client Returns	21.8%	16.1%	-2.4%	-24.6%	14.2%	1.8%	20.9%
S&P 500 Return	6.2%	15.2%	5.1%	-39.0%	26.3%	5.1%	4.1%
Difference	15.6%	0.9%	-7.5%	14.4%	-12.2%	-3.3%	16.8%

As shown above and on the previous page, client portfolios had outstanding performance from inception in March 2005 up to October 31, 2007 when cumulative returns peaked at 56%. 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 barely beat the overall market – a surprise Canadian tax increase on energy trusts took a chunk out of returns that year. In 2007 we had further big gains in energy prices that helped the portfolio post strong returns up to October 31st, but the impending recession induced by the credit market problems pulled our portfolio down along with the rest of the market in the last two months.

In January 2008 we put on hedges against further expected market declines. Consequently we did not lose money for the first 6 months of 2008. After that, the rapid drop in oil prices and very high volatility rendered our hedging instruments less effective than expected. Still, we were able to break even in October 2008 when the market was crashing and our portfolio was also close to break even in the early 2009 market drop. After accounting rules were weakened so banks could hide their losses and pass the stress tests, the market began its recovery - but with a great deal of risk now hidden from view. After the market bottomed in March 2009, we remained defensive throughout the subsequent rally because we were more concerned with protecting against principal losses than speculating on a favorable market response to a “less bad” economy. This caused us to lag the overall market significantly though our clients still earned very good returns (without taking undue risks). With such large risks it not a time to be greedy. There will be plenty of opportunities for more smart risk taking in the future - so long as we preserve our clients’ capital.

Client returns data includes reinvestment of dividends after netting out fees and expenses. Note that our client portfolios are much less diversified than the S&P 500 index and therefore may exhibit higher short run volatility. Our view is that short run volatility is not an appropriate measure of risk of loss for long term investors. Still, we did use hedging to reduce volatility over the last 2 years so as to avoid large unrealized losses which might cause clients to sell at the worst time. As a result the monthly volatility of returns for our portfolio over 5 years is lower than the S&P 500 (14.3% vs. 16.2%).

In summary, our clients have managed to outperform the market over the last 5 years while taking less risk. Although cumulative returns to date are somewhat unimpressive on an absolute basis, by sticking with our strategy we are well positioned to withstand further declines and produce outstanding returns as uncertainty is resolved and the balance of returns and risks become more favorable.

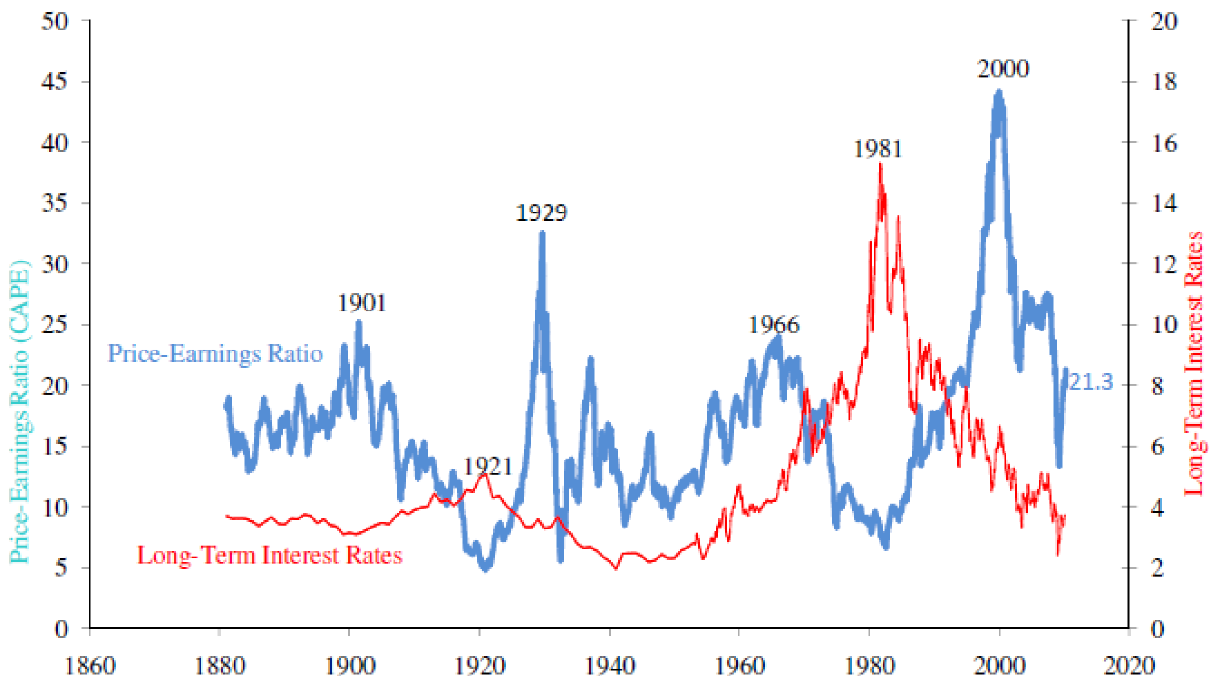
Current Market Environment

For the most part, businesses have adjusted to the lower levels of consumer spending. Government policies will slow down the economy's adjustment process so as to spread the underlying problems over 5 to 10 years or more - just as Japan did when its real estate bubble popped in 1989. Buying time this way is good in the short run as it reduces fear, thus eliminating panic driven decisions that make matters worse than they need to be. In particular I refer to government programs aimed at absorbing losses on consumer mortgage debts by printing money and borrowing from foreign lenders on our behalf. By this method we lower future income to smooth out the drop in current income. The government has also acted to shift income from savers to spenders by lowering interest rates to near zero. This shift of income from low spending seniors and foreign creditors to high spending housing speculators (via the banks) cushions the drop in economic activity that would otherwise occur.

While the most severe part of the economic upheaval is behind us, there are still some problems that could disrupt the robust recovery that the market has priced into stocks. Since last March regulators and accountants have suspended reality accounting at the big banks in order to allow time for low interest rates and inflationary growth to bring the banks back to solvency (some day). Despite this leniency, there is risk that another surge of defaults combined with the existing non-performing loans becomes too large to ignore. This could lead once again to panic and credit crisis – which would affect business activity and push stock prices down.

A second potential problem is long term interest rates. There are signs that our largest creditors, China and Japan, are backing off from unlimited funding at low interest rates. If long term rates rise, this will dampen economic activity and may also cause a drop in stock valuations.

Most worrisome in the short run is the very high levels of stock valuations relative to the downside risks mentioned. The graph below shows historical price to earnings ratios for the S&P 500 using trailing ten year inflation adjusted earnings.



This data comes from Dr. Robert Shiller of Yale University. Currently this P/E ratio is 21.3. The average since 1926 is 17.4 so we are at a valuation level 22% above this long run average despite serious underlying risk factors including the likelihood of higher inflation, higher interest rates, and higher taxes.

If we take a close look at the data we see that prior to the bubble period that started in 1997 it was very rare to see this P/E ratio go above 25. In fact from 1930 to 1996 the P/E exceeded 25 in just 12 months. Since 1996 we've had 115 months in which the P/E exceeded 25 and the average over this period is an amazing 28.7. This is a big reason why stock returns overall have been poor – buying prices have been too high relative to fundamentals and risks. In contrast, the P/E ratio of our Long Term Value portfolio is roughly 60% of the S&P 500 P/E ratio. The high valuations in the market certainly do not guarantee a decline is coming – the data clearly show that P/E ratios can remain "too high" for long periods – but such pricing levels imply much higher probability of low or negative returns than if we were at more normal levels.

While we cannot really know what causes the market to bid stocks to P/E multiples seemingly disconnected from underlying fundamentals, I hypothesis that a main cause has been the shift towards passive investing that flowed from the ideas described as "modern portfolio theory" and "the efficient markets hypothesis" which have been taught widely in finance curriculums since the 1980s. If you believe that market prices reflect true value and all one can do is allocate assets to achieve good diversification, then you will not care what price you pay. Therefore, as these notions gain more adherents, the proportion of "dumb money" in the market increases and stock prices can drift far from underlying company values for extended periods.

Investment Strategy Update

Currently, we remain defensive due to the two factors mentioned above, namely: 1) there are still potentially large hidden losses embedded in bank balance sheets and we are waiting for more data on the size of these losses to come out, and 2) overall market valuation multiples are very high relative to the weakened state of the economy and thus there seems to be more downside risk than upside potential. We hope and expect this situation will resolve itself over the next few months.

As prices of stocks have been bid up we have sold quite a few stocks lately from The Long Term Value Portfolio. This has caused cash to rise to 26% of the portfolio and has reduced our exposure to oil significantly. Given the high prices in the market, we will take our time to find bargains before redeploying this money. As the Real Estate Investment Trust (REIT) market has rallied we have sold very little of our REITs as they remain undervalued. Their weighting has grown to 17.4%. We expect significant dividend growth from these positions which will push up prices as well. To protect against potential dollar devaluation and inflation we have about a third of the portfolio in precious metals, energy, and foreign stocks. Going forward we are looking for foreign stocks that will be less affected by U.S. problems but that are still selling at bargain prices relative to earnings and growth prospects.

In general our equity core strategy is, as always, buying stocks at a discount to the true value and selling when the market price exceeds the value. Anyone can read about this strategy in the classic investing book "The Intelligent Investor" by Benjamin Graham – Warren Buffet's teacher and mentor. I don't mind giving this "secret" away as I know full well that following this strategy successfully is a lot of work and requires expertise and emotional control that most people simply do not have.

Despite the natural risk management that comes from buying low-priced stocks, we also seek to manage the market risk that comes from shifts in the macro-economy or investors' fears. By doing so, we help our clients avoid (or at least reduce) the emotional pain of short term losses; thereby enabling them to stick with their investment plan. Consequently we remain partially hedged against a market decline in the face of rising interest rates and overall market valuation levels that appear too rich for the slow recovery expected by economists – including myself. In the next few months, I expect that either we will find out that the uncertainties are resolved in the favor of the market's optimistic projections or the market will sell off if things turn out not as rosy as expected. Either way, we should be in a position to reduce hedging and find new investments with acceptable returns for the risks.

Announcements

On March 23rd, an investing website called Seeking Alpha published my article about one of our holdings, Caplease. The stock has risen about 10% since publication – 20% since I started writing it at the beginning of March. If you're interested in seeing how I analyzed this particular stock, you can read the article at this link: http://seekingalpha.com/article/194674-high-conviction-an-underpriced-commercial-reit

We are pleased to announce that Herb Meiberger has joined the firm. Herb has an MBA in finance from U.C. Berkeley and is also a Chartered Financial Analyst (CFA). In addition to his affiliation with Berkeley Investment Advisors, Herb teaches finance at San Francisco State University and CFA review courses. Herb also will continue as a Commissioner of the City & County of San Francisco Employees' Retirement System. The Retirement Board oversees the $13.5 billion (12/31/09) Defined Benefit pension fund and the voluntary $1.8 billion Defined Contribution fund. Herb has served on the Retirement Board since 1992.

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