Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

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Investment Newsletter – May 2005

The Berkeley Investment Advisors' Parked Money 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 4th of a series in which I explain details about construction of the four risk profile portfolios. Since this portfolio is essentially an alternative to a money market account, I will explain why there is an opportunity to add value versus a generic money market fund. I will also give some example trades that would be used for this portfolio.

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

This portfolio is meant for clients who need a place to "park" money in the short term while they wait for a real estate deal or some other use for the funds. The objective is to beat after-tax money market returns by 1% or more while keeping risk very low. This portfolio will invest in preferred stocks, bonds, and exchange traded funds (ETFs) where the underlying securities are short term (< 5 year maturity) bonds. The ETFs provide greater liquidity than preferred stocks and diversification benefits since these represent ownership of an underlying portfolio of bonds. The preferred stocks provide higher yield but will not provide as much diversification[1] or liquidity.

The preferred stocks must meet the following criteria:

1. Dividend rate tied to a short term interest rate index so that their value is relatively insensitive to the level of interest rates.
2. Company has an investment grade rating from at least one of the major rating companies.

[1] This is because of limitations of the brokerage platform as well as those imposed by our investment criterion.

We will focus on preferred stocks that qualify for the 15% tax rate but may take positions in non-qualified preferred stocks if the yield is high enough to cover the higher taxes. We will limit positions in any one preferred stock to one day's average trading volume. The value of the portfolio will fluctuate with changes in credit market conditions. While the portfolio may incur small losses from time to time, I consider it very unlikely that the portfolio will experience a loss over a 12 month period.

Economics of Liquidity: Market Segmentation and Returns

In this section, I will explain the reason why there is an opportunity to significantly boost returns without a corresponding increase in market risk. It is said that you get paid for taking on risk, but you also get paid for venturing into market niches with less liquidity (and therefore less institutional participation). In such niches, the value of information and analysis is greater in terms of percentage returns (but not big enough in dollar terms to draw in the resources of the big players). The real estate market is a perfect example. It is much less liquid than traded securities but the returns more than compensate those who can forecast their cash needs (assuming they buy the right property).

Private equity and hedge funds are in business to capture the returns from less liquid positions by applying intensive information gathering and analysis in their chosen niches. By focusing on areas that institutions cannot participate they can earn excess returns by becoming experts. This phenomenon has an economically sound underpinning. The scale of capital that participates in large liquid securities is such that it takes only a small percentage of assets to pay for a lot of research and analysis dollars. Thus the market becomes "efficient" and returns are driven down as the depth of knowledge drives down uncertainty.

My hypothesis is that the liquidity premiums we see in the market are a function of the value of information for a given security. Knowledge based investors require a certain amount of information analysis to reduce risk to an acceptable level. In order to make it worthwhile to invest in this analysis for smaller positions, the percentage return required goes up. In other words, prices will be set such that expected returns cover the cost of reducing uncertainty about a particular security to an acceptable level.

I will illustrate with an example. Suppose it costs $500 to learn enough about a security to invest in it and you've got a large enough portfolio that you can put $10,000,000 into any one position and still be diversified. You can invest the whole amount in a single large corporate security or you can spread it out among 100 different preferred stocks by investing $100,000 in each. You can't invest more than $100,000 in these preferred stocks because trying to move more money in too quickly will push prices up too much (and thus push returns down). The cost of information on the first choice represents .005%. For the preferred portfolio the cost is .5%. Market prices and the implied returns must therefore adjust so that preferred stocks provide returns at least .495% higher than more liquid alternative investments.

The implication of this is market segmentation rooted in economies of scale. Investors with very large portfolios will concentrate their analysis resources and investments on securities with enough liquidity to handle the scale they need to operate at. Smaller investors cannot reap these economies of scale and will maximize their returns by focusing on market niches where they can earn higher returns to cover their cost of information analysis. To make this second conclusion clear consider an example from the point of view of the smaller investor.

The small investor's portfolio is smaller so that he cannot put more than $100,000 in a security without becoming too concentrated (increasing risk). He can put that $100,000 in the same liquid corporate bond that the big investor would or he can buy the preferred. Either way his cost of information analysis is the same, but notice that the returns on the liquid security are expected to be .495% less than those on the (less liquid) preferred stock. Moreover, since the smaller investor only needs to move $100,000 at a time, he can sell his position with minimal market impact just as easily as the bigger investor can sell his $10 million position. Therefore, the smaller investors will earn excess returns relative to the market by investing in less liquid securities.

Example Trades to Illustrate Trading Strategies and Results

Given my personal return goals and risk tolerance, I have not followed such a low risk strategy in the past. The examples I will give here are therefore not trades I have actually executed; they are positions chosen from current possibilities to illustrate the preferred stock strategy of this portfolio.

My first example is Lehman Brothers preferred series G. Lehman Brothers is an investment bank. This is a variable rate preferred, whose dividend rate resets every month at .75% plus the one-month London InterBank Offered Rate (LIBOR). Unlike general money market funds, the dividends are taxed at the 15% federal rate. This stock has a par value of $25 per share. At May 31st it closed at $24.65 per share. The dividend rate reset on 5/18/05 to $.96 annually, a current yield of 3.89%. Lehman Brothers is rated BBB+ by S&P.

As an example of an ETF, the portfolio would buy the iShares Lehman 1-3 year Treasury Bond fund. This fund currently yields 2.81%. An example of a straight bond purchase would be Boeing Capital Corp. Internotes due 12/15/2005. These bonds yield 3.65%.

Conclusion

The Parked Money portfolio offers conservative investors the potential for enhanced fixed income returns relative to money market accounts. The strategy is to focus on less liquid preferred stocks so as to capture the additional returns available in these securities. 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.

Market Notes

Apparently the predicted drawdown in oil inventories has begun earlier than expected and oil prices rebounded beyond $50. The energy stocks in the Long Term Value Portfolio rebounded along with oil though they are still cheap relative to value in my opinion.

The mortgage industry has released information showing that an increasing portion of mortgages are adjustable rate and may have no principal payments for the first few years. Much of this debt has been put in place on investment property and 2nd homes. Effectively people are betting on rising rents or more likely appreciation unconnected to rental market fundamentals. In my view this phenomenon significantly increases the impact of Federal Reserve increases in short term interest rates. As short rates rise there will be a significant transfer of money from households to banks. Some of this will be passed on to depositors but enough will be taken out of overall demand that it could tip the economy into recession much faster than rate increases have in the past. On the other hand, Greenspan is the master of statistics and may well anticipate the increased effectiveness of rate increases. Thus, he may not raise interest rates as high as past experience would seem to indicate. This analysis is a possible explanation for the failure of long term rates to move up along with short term rates. This moderating effect on long term interest rates reduces some of the risk for long term fixed income investors and thus makes investments that are particularly sensitive to long rates, like triple net leased real estate, bonds, and fixed rate preferred stocks, relatively more attractive than has historically been the case in a rising rate environment.

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