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Investment Newsletter – March 2019

This quarter we will discuss the significance for investors of the yield curve inversion that has been in the news this past week. We'll also look at the new 20% tax deduction for real estate investors included in the 2017 tax law changes. Finally, we'll wrap up with a review of the performance of the Short Term Income strategy and where things stand with some of the underlying market factors that influence returns on this portfolio.

Bond Market Recession Signal

On March 22nd, for the first time since 2007, the yield curve inverted - meaning the 10-year Treasury bond interest rate fell below the 3-month Treasury interest rate. You probably saw press reports saying that the yield curve has inverted prior to every recession since 1975. Less mentioned is that not every yield curve inversion is followed by recession and that it can take a few years till a recession occurs if one actually materializes. Another mitigating factor in interpreting the current situation is that this is the first inversion of the new era in which the Federal Reserve tries to directly push long term interest rates lower through purchases of long maturity Treasury bonds. So it's a muddy signal at best. What we can say is that this indicates that bond market participants believe that future short term rates will be lower than they are now. This implies the Federal Reserve will reduce rates to counteract slowing economic activity. With unemployment as low as it is, this seems unlikely in the near term.

When Rental Real Estate Income Qualifies for the New 20% Tax Deduction

In section 199A of the Internal Revenue Code, the new tax law for 2018 included a 20% deduction for businesses not conducted via a taxable corporation. Dividends from a real estate investment trust or a publicly traded partnership can qualify for the deduction. Income from rental real estate may also qualify.

Internal Revenue Service (IRS) Notice 2019-07 lays out the circumstances under which the IRS will treat rental real estate as a qualified trade or business for purposes of getting the deduction. Note that the calculation methodology is applied to each separate business you own on a stand-alone basis and the deduction is then the total across all your businesses. IRS Notice 2019-07 specifies that commercial and residential properties must be considered as separate businesses.

Rental property income can qualify for the deduction if all of the following conditions are met:

A. Separate books and records are kept for each rental real estate business.
B. 250 hours or more of rental services are performed per year. Rental services are: advertising, leasing, tenant screening, daily operations, maintenance, repairs, property management, purchases of materials, and supervision of employees and contractors. These services may be performed by owners, employees, agents, or contractors.
C. Time reports, logs, or similar documents are kept to provide information on hours of all services performed, descriptions of the services, the dates of the services, and who performed the services. (This does not apply for 2018).
D. The property is not subject to a triple-net lease.

When a taxpayer uses the above rules to qualify rental real estate for the deduction, they must attach a signed statement to the tax return certifying that the conditions have been met. Even if the above tests are not met, a taxpayer could still argue that the rental business qualifies for the deduction, but that position could be challenged by the IRS.

Calculating the actual deduction depends on several key facts in your tax situation. This is a complex law with many possible scenarios. To simplify our analysis, we first classify the various tax variable combinations into a set of cases that require similar calculations. In all cases the deduction cannot exceed 20% of ordinary taxable income[1].

There are different rules for the three categories of income that may qualify for the deduction. The three categories are:

1. Real Estate Investment Trust (REIT) dividend income and Publicly Traded Partnership (PTP) income.
2. Business Income from one of the specified service trades or businesses (abbreviated SSTB), defined as:
   "*Providing services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, dealing in certain assets or any trade or business where the principal asset is the reputation or skill of one or more of its employees.* "
3. Qualified Business Income not related to one of the specified service trades or businesses as defined in category 2 above. This last category includes rental real estate income – the focus of this article.

The law also treats taxpayers differently depending on their level of taxable income relative to a threshold level and a proration range (limitation phase-in). For 2018 the threshold amount is $157,500 for single, and $315,000 for married taxpayers.[2] The proration range is the next $50,000 above the threshold for single taxpayers and $100,000 for married taxpayers. Adding the proration range to the

[1] Ordinary taxable income means total taxable income after subtracting net capital gains.
[2] These amounts are indexed to inflation for future tax years.

threshold level gives an upper-bound dividing line between category 2 and category 3 so that we have three possible situations for taxable income:

1. Below the threshold – meaning less than $315,000 if married, or less than $157,500 if single.
2. In the proration range – meaning $315,000 to $415,000 if married, or $157,500 to $207,500 if single.
3. Above the upper bound – meaning greater than $415,000 if married, or greater than $207,500 if single.

Now let's classify the nine permutations and analyze them by grouping similar outcomes into "cases". Note that rental real estate is in the category "Other than SSTB Business Income".

	Categories of Income for Calculating Deduction		
Taxable Income	REIT or PTP Income	Other than SSTB Income	Specified Service Trade or Business Income (SSTB)
Below threshold	Case 1	Case 1	Case 1
In the proration range	Case 1	Case 2	Case 4
Above the upper bound	Case 1	Case 3	Case 5

As a reminder, in every case the deduction is limited to 20% of ordinary taxable income if that amount is less than the calculated deduction. We will refer to the second row of the table as the phase in range - which is a range of $50,000 in taxable income for singles or $100,000 for married couples.

First let's cover the simplest cases.

For Case 1 in the table, the deduction is 20% of the income in the category.

For Case 5 in the table, you do not qualify for any amount of the deduction.

For Cases 2 to 4 we must calculate what I'll call the Limitation Amount. This Limitation Amount is the greater of 50% of W-2 wages paid by the business, or 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property used in the business.

For Case 3 the deduction is equal to the Limitation Amount described above.

Case 2 is more complex. In this case, the deduction is reduced from 20% of category income pro-rata down to the Limitation Amount. The reduction is proportional to the amount of taxable income that is in the proration range (from the threshold amount to the upper bound) relative to the full phase-in range.

For an example of the calculation in Case 2, consider the following scenario relating to real estate rentals that meet the guidelines for a qualified business:

Single Taxpayer

A. Ordinary taxable Income = $177,500
B. Qualified Business (rental) Income = 60,000
C. W-2 wages paid to manage the rentals = $6,000
D. Unadjusted basis of qualified property used in the business = $200,000

In this scenario the Limitation Amount is $6,500 computed as 25% of C = $1,500 + 2.5% of D = $5,000. We use this rather than 50% of C = $3,000 because $6,500 is the greater of the two possible limitation amounts. Without any limitation the deduction would be 20% of B = $12,000. Therefore the limitation-related reduction amount we are prorating is $5,500 (= 12,000 – 6,500). We calculate the

percentage of this reduction as (taxable income $177,500 - $157,500, the threshold amount) /50,000, the proration range. So in this example 20,000/50,000 = 40% of the reduction is applied. Thus the section 199A deduction is calculated as $12,000 - $5,500 * 40% = $9,800.

Case 4 is the most complex. For this, calculate the Case 2 deduction and then multiply by (100% - the amount of taxable income over the threshold/the proration range). Therefore, assuming the example numbers above but that income was from an SSTB, the deduction is calculated as $9,800 * (100% - 40%) = $5,880.

These calculations may seem daunting, but in fact they can easily be implemented in a spreadsheet once we have reduced the complex wording of the law to this set of cases and formulae. Of course, we have to be careful to make sure we understand the definitions of the various input variables. In some cases, this may require the advice of a tax expert. This deduction can produce significant tax savings for real estate investors and thus it is worth spending some time to make sure you understand it and that you organize your real estate rental business so that it meets the criteria specified by IRS Notice 2019-07 as detailed above.

Short Term Income Portfolio Strategy and Performance

Berkeley Investment Advisors uses several different strategy portfolios to manage client assets. The Short Term Income portfolio is a fixed income portfolio that focuses on short to intermediate term rate maturity loans and bonds. Typically shorter maturity bonds offer lower interest rates (yields) than longer maturity bonds and are less sensitive to changes in interest rates. This category of fixed income includes securities with floating interest rates that can reset periodically depending on market conditions. For example the rate paid could be set based on the 3-month London Interbank Offer Rate (3-month LIBOR). This rate, in turn, changes as the Federal Reserve Bank raises (or lowers) it's "Fed Funds Rate".

The interest rate risk sensitivity risk of the portfolio is measured by its duration. Typically a short term bond fund strategy would own bonds with durations below 3. If we held a bond with duration of 3 when rates went up 1%, we would expect the bond's price to decline by 3%. In the current environment where interest rates are historically low, we have chosen to keep portfolio duration to an even lower level – currently 1.2.

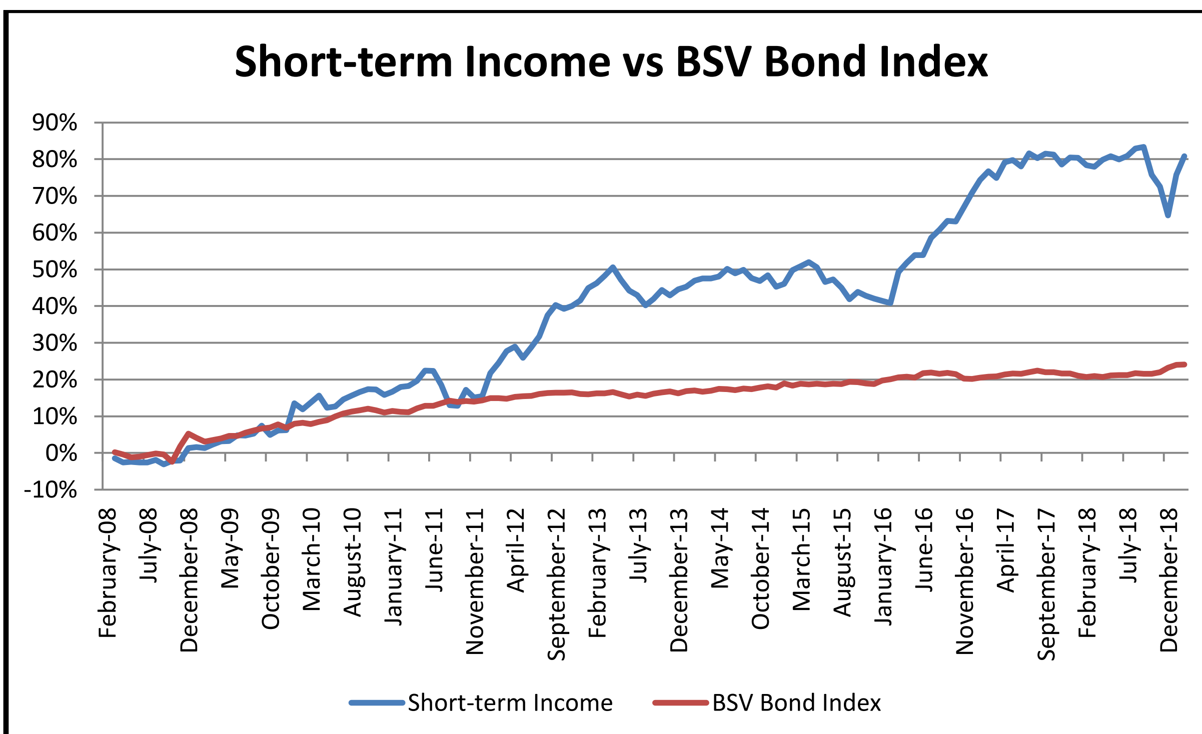
There is also credit risk in our portfolio –borrowers may default and not pay all that is due. High yield bonds have a higher probability of default than investment grade rated bonds but these lower rated bonds compensate by paying higher interest rates. It is this spread compensation that fluctuates depending on the market's current risk pricing attitude (mood). This pricing risk is related to equity market risk and it is also correlated with the performance of the economy. We manage individual credit risk by diversifying across a large number of issuers. This ensures that the extra premiums earned will not get wiped out by a few companies defaulting. Our strategy is to accept credit risks to earn the extra returns associated with those risks.

The portfolio also earns incremental yield by holding closed-end funds (CEFs). For a detailed explanation of the advantages of closed-end funds see the March 2017 newsletter. In holding these securities we must endure more price volatility

in down markets as retail investors tend to want to sell more at lows. Current market conditions are providing about 1.0% higher yield on our portfolio than if we held the underlying bonds directly.

The portfolio is diversified across virtually all sectors of the fixed income market. The best comparison index is the "Barclays U.S. 1-5 year Government /Credit Float Adjusted Bond Index" as represented by the Vanguard Short-Term Bond exchange traded fund (ticker BSV). This is meant to represent the total short maturity U.S. bond market. It is not a perfect comparison to our strategy but there is nothing closer that has been in existence for the life of our portfolio.

At least some clients have had money invested in this portfolio since it was created in February 2008. The graph below and the table on the next page show total returns including price and interest payments in comparison to the bond index mentioned above as implemented in the exchange traded fund (ticker BSV). Our portfolio returns calculated here are based on a particular client's account and have been reduced by annual fees of 1.25% which would apply to new accounts above $500,000 but below $1 million.



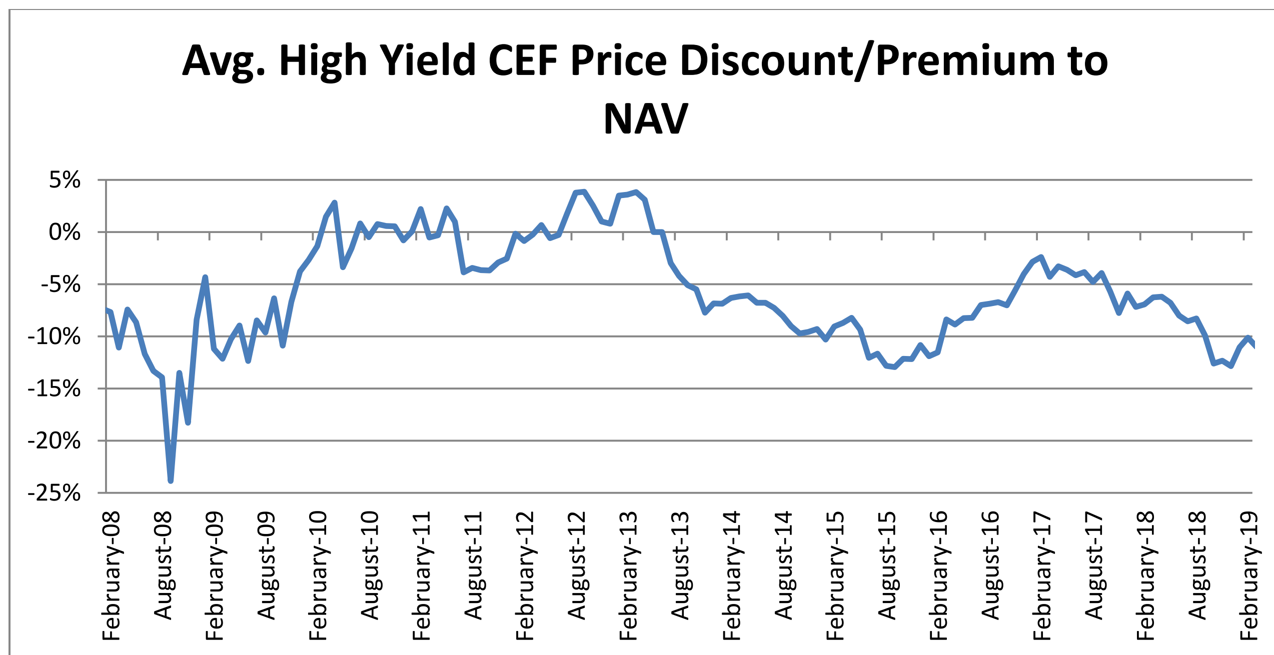
The cumulative return for the strategy from 2/29/2008 to 2/28/2019 is 80.8%. **Thus the annualized compounded rate of return since inception (11 years ago) has been 5.5%.**

The graph above shows moderate volatility for the strategy's returns. Although this strategy did incur a minor loss in its 8th year, generally there is much lower risk of principal loss over a year's time than in other strategies - such as stocks or long term bonds. Relatively large allocations to this strategy should serve to reduce risk for clients when other asset classes have elevated risks. The stock market looks particularly risky using historical norms. We want to avoid large losses and have funds available to buy when the market returns to a lower level.

The table below breaks down the portfolio returns by year since inception. Over the last year, the strategy returned just 1.4% which was below the 2.9% return earned by the Vanguard Bond Index Fund. Although, the last year was not a good one for this strategy, as we will discuss, we have good reason to expect improved returns this year.

Year	Year Ended	Short term Income	BSV Bond Index	Difference
		Returns by Year		
1	2/28/2009	1.4%	3.1%	-1.7%
2	2/28/2010	10.3%	5.0%	5.4%
3	2/28/2011	5.5%	2.7%	2.8%
4	2/29/2012	5.5%	3.4%	2.1%
5	2/28/2013	17.5%	1.1%	16.3%
6	2/28/2014	0.5%	0.6%	-0.2%
7	2/28/2015	2.0%	1.2%	0.8%
8	2/29/2016	-6.0%	1.5%	-7.4%
9	2/28/2017	25.5%	0.6%	24.9%
10	2/28/2018	0.9%	-0.1%	1.0%
11	2/28/2019	1.4%	2.9%	-1.5%
	Compounded Total	80.8%	24.1%	56.7%

Up until April 2013 returns were quite good but then market conditions pulled returns below normal for the next 3 years. By February 2016 the market for these securities was extremely undervalued based on several indicators. One of these indicators is the level of closed end fund discounts. Below is an update of the usual chart showing the time series of an average of 7 CEFs we've tracked since 2008.



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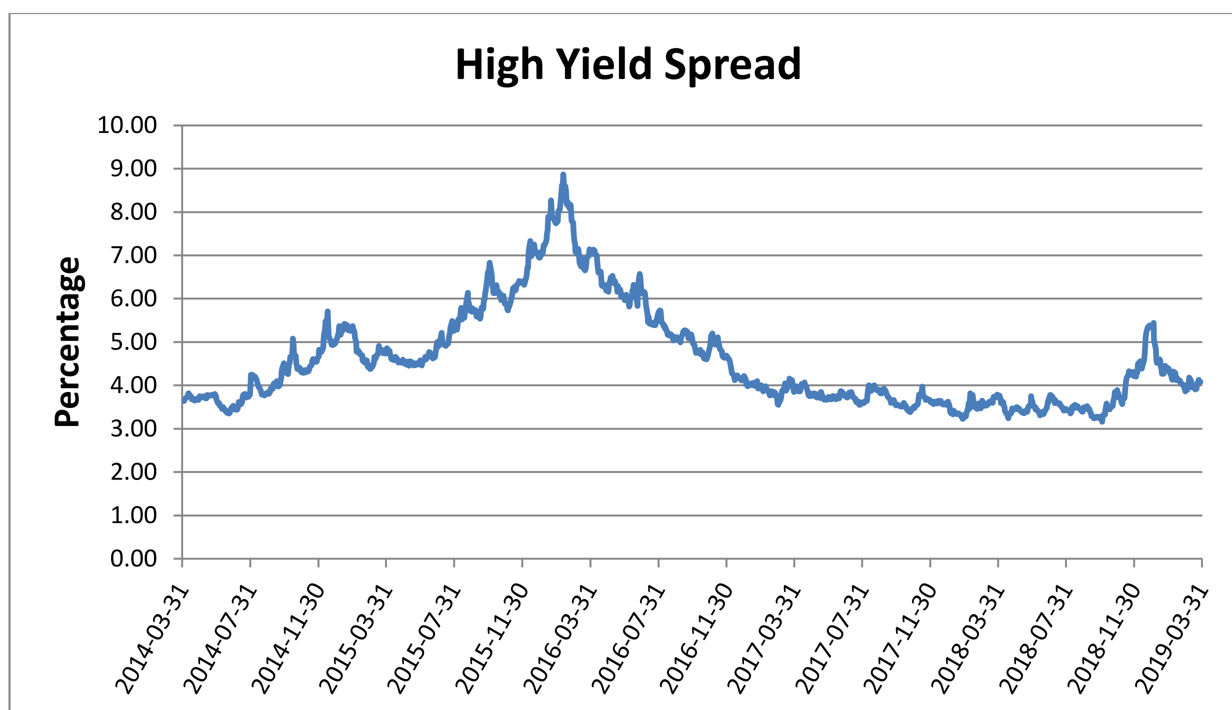
The median level since 2008 for average discounts for CEFs as shown in the chart above is 6.68%. For these CEFs, discounts had mostly turned to premiums by April 2013 and then descended back to very wide discount levels by February 2016. Subsequently discounts moved back toward their central tendency, boosting returns for us to over 25% in the year ended February 2017. Since then discounts have been widening the last 2 years. Discounts are now much wider than the median of the last 11 year. They hit 12.9% at the end of December, prompting me to send out an email to clients highlighting the buying opportunity of such an extreme discount level. The portfolio returned 9.8% from then to the end of February. The average discount is now 11.0% as of 3/29/19.

Over the year ended 2/28/19 the average CEF discount in the chart above increased from 6.9% to 10.1%. This is the second year in a row where discounts increased more than 3%. The weighted average discount for CEFs currently in the Short Term Income portfolio is 9.3%.

Spreads on underlying high yield bonds also fluctuate depending on the economic outlook and investors' attitudes towards default risk. The chart below shows the Bank of America High Yield Spread index over the last 5 years.



In this chart, higher spreads indicate lower bond prices (and higher forward yields). Thus the spike up to a spread of 8.87% in February 2016 implies a decline in market values of high yield bonds. This combined with the widening of CEF discounts to produce a negative return for the strategy that year. This spike was somewhat usual and represented a buying opportunity. The median spread over this past 5 years has been 4.2%. Spreads are currently at 4.08%.

The portfolio positions change throughout the year; overall the weighted average net asset values of our positions declined. These decreases offset most of the interest collected for the year, leaving us just a very slight net return.

Meanwhile, dividend income from the funds has risen as the Federal Reserve has raised interest rates. Combining this with lower market values means a higher yield on the portfolio going forward. Overall the current portfolio yield before fees is 7.7%, compared to 6.5% last year. Looking forward, increases in high yield spreads may reduce returns a bit in the short run (relative to the current yield) but this should lead to higher returns going forward.

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