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Investment Newsletter – September 2019

This newsletter starts with an update of the performance of the Long Term Income strategy as of September 2019. Following that is a discussion of the key considerations when shopping for long-term care insurance.

Long Term Income Portfolio Strategy and Performance

The year ended 9/30/2019 produced a 10.6% return which is significantly above the long run average compounded return of 8.22% for the Long Term Income strategy. The return for the year, measured after fees, matched the bond index that serves as the comparison benchmark for the portfolio (as discussed below). These results are higher than we should expect as they are driven by declines in interest rates because of investors' concerns about economic growth.

In the prior year, ended September 2018, the portfolio's return was slightly negative because of a huge increase in interest rates during that year. Our higher than normal returns this year can thus be seen as a payback for the loss last year. This cycle of up and down years is normal; we must employ a long term perspective to evaluate portfolio performance.

Berkeley Investment Advisors uses several different strategy portfolios to manage client assets. The Long Term Income portfolio focuses on taxable intermediate to long term maturity bonds. Longer maturity bonds provide higher interest rates (yields) than shorter maturity bonds and are more sensitive to changes in interest rates. A bond's interest rate sensitivity risk, known as its duration, tells us how big a change in price we can expect when interest rates change. The duration of the portfolio is currently at 4.3 but it was 4.5 last year. If we hold a bond with duration of 5 when rates went up 1% we would expect the bond's price to decline by 5%.

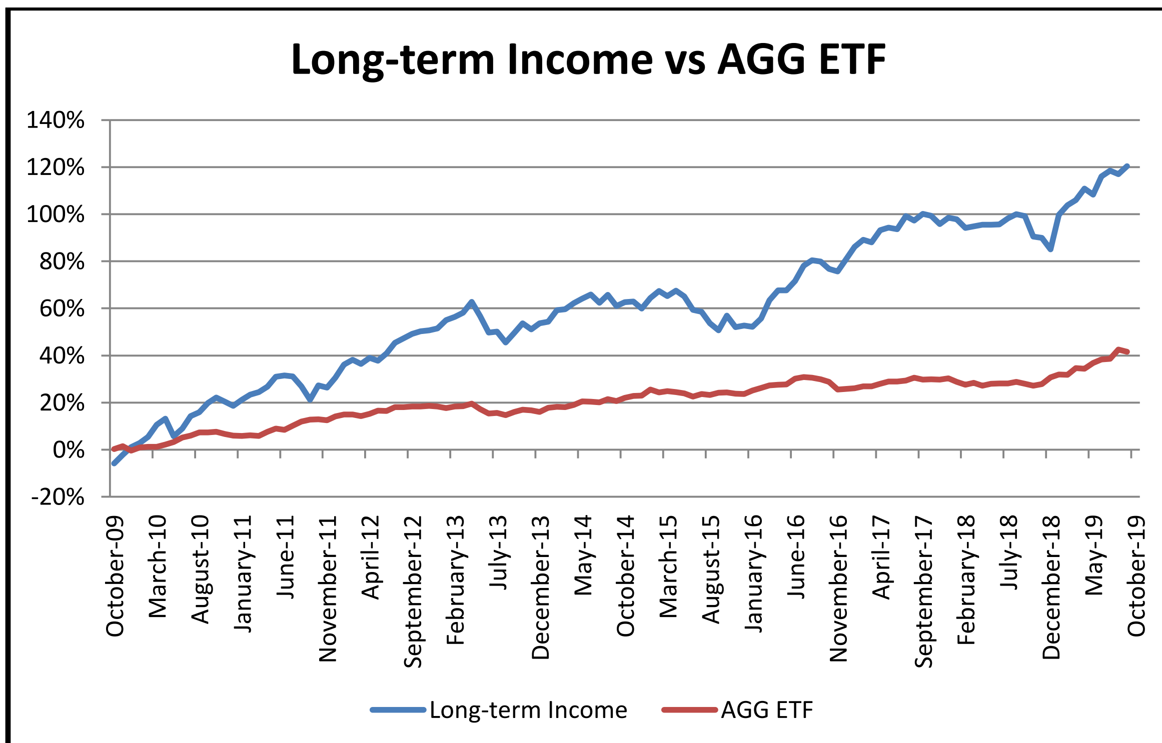
Besides interest rate risk, there is also default risk in this portfolio. Bonds with higher probabilities of default (relative to other corporate bonds) compensate investors with higher interest payments – hence they are called "high yield" bonds. High yield bond default risk is like stock market risk - it is correlated with the performance of the economy. At the portfolio level we diversify away individual company default risk by diversifying across a large number of issuers. This insures that the extra premiums earned won't be lost due to a few companies defaulting. Our strategy is to accept market correlated credit risks to earn those extra returns.

The extra return on high yield bonds over the interest rate paid by the U.S. treasury is called a credit spread – it is the compensation that investors demand for taking credit risks. These spreads change according to investors' risk preferences – i.e. how much they need to get paid for taking credit risk changes according to market mood just like stocks. Therefore by accepting default risk we also accept credit spread "pricing risk" and we must endure fluctuations in our portfolio value that correspond to changes in the market mood - risk seeking or risk aversion– but at roughly half the level of stock market moves.

We also earn incremental yield by buying closed-end funds (CEFs). These securities can be bought at discounts to the underlying bond values (and occasionally sold at a premium). These funds also enhance returns through embedded leverage. Using these securities means we must endure more price volatility in down markets because most retail investors want to sell more at lows. Current market conditions are providing about .95% higher yield on our portfolio than if we held the underlying bonds directly. Now that I've described the strategy and its sources of risk, we'll go over the returns for it and the comparison index.

The Long Term Income portfolio is diversified across virtually all sectors of the fixed income market, including government bonds and mortgage backed securities. A good comparison index is the Barclays U.S. Aggregate Bond Index as represented by the iShares Core Total U.S. Bond Market exchange traded fund (ticker AGG). This is meant to represent the total overall U.S. bond market.

Although we first created this portfolio in February 2008, it was not continuously invested until September 2009. Therefore we cannot calculate performance further back than the last ten years. The graph and table below show total returns including price and interest payments in comparison to the bond index mentioned above, as implemented in the exchange traded fund (ticker AGG).



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.

	Returns by Year		
Year Ended	**Long Term Income**	**AGG Bond Index**	**Difference**
9/30/2010	19.8%	7.4%	12.4%
9/30/2011	1.2%	5.0%	-3.8%
9/30/2012	23.1%	5.0%	18.1%
9/30/2013	0.2%	-2.0%	2.3%
9/30/2014	7.6%	3.9%	3.7%
9/30/2015	-6.4%	2.7%	-9.1%
9/30/2016	19.4%	5.0%	14.4%
9/30/2017	11.3%	-0.1%	11.4%
9/30/2018	-0.5%	-1.3%	0.9%
9/30/2019	10.6%	10.6%	0.0%
Compounded Total	120.4%	41.6%	78.7%

Total return over ten years is 120.4% - an annualized compound rate of return of 8.22%. The table above makes it clear that the strategy exhibits significant volatility in returns but over the long run the results are quite good. This variation in yearly returns is driven mostly by changes in the market value of securities which I refer to as the "mark-to-market return". Long run returns, however, are driven mainly by the interest payments from the securities as the gyrations in market valuations tend to cancel each other out over a period of years.

For the year ended 9/30/2019 the interest rate on 10-year treasury bonds decreased from 3.05% to 1.67%. I estimate that this interest rate decline increased the market value of the portfolio by around 5.94% compared to last year (4.4 average duration times the 1.35% interest rate decrease). Remember our portfolio value moves in the opposite direction of interest rates.

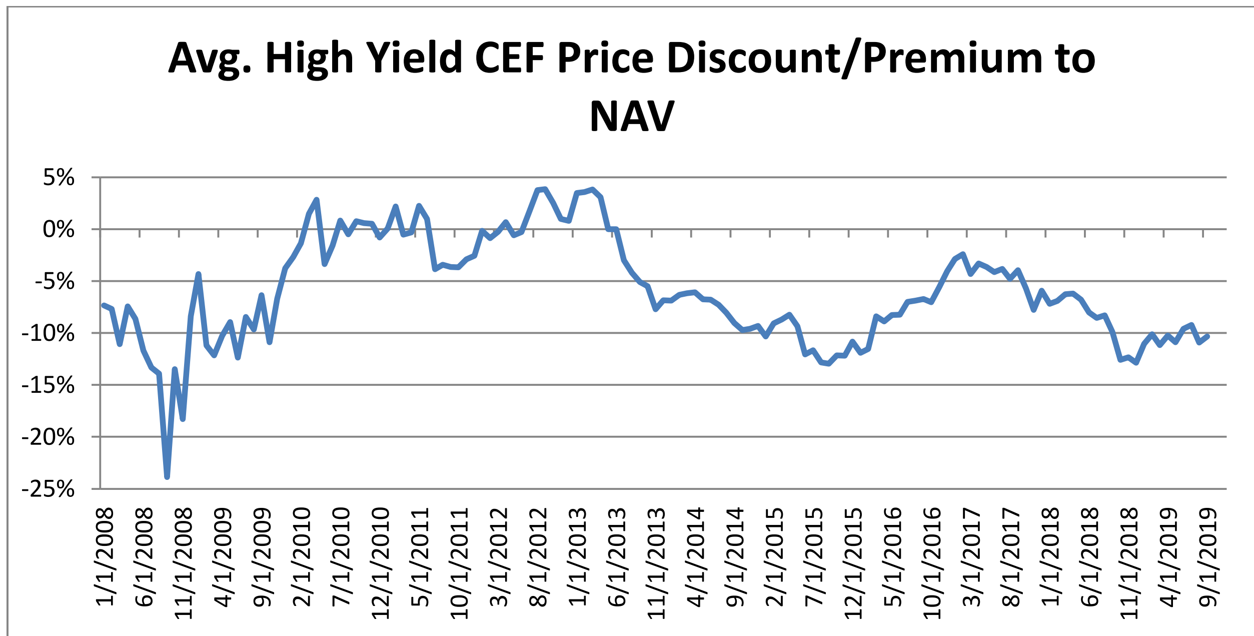
Credit risk spreads increased by .71% over the year to 3.99%, which reduced returns on a mark-to-market basis for the underlying bond net asset values (NAVs). This offset the positive effect of lower treasury rates, creating a 3.12% headwind for overall returns. We frequently see spreads increasing as risk free rates decline because these moves correspond with expectations of a slowdown in economic growth. Even with the increase, credit spreads are still significantly lower than average levels at 9/30/19.

The portfolio's price returns (i.e. not counting interest payments) can also be impacted by changes in CEF prices relative to the underlying bonds. To determine the impact we can look at monthly prices and net asset values (NAVs) for some representative CEF holdings. NAV represents the value of underlying bonds inside the closed end funds and the difference between price and NAV is the discount that funds trade at relative to value.

To get an idea of how much CEF discounts can vary, I pulled data on a group of seven CEFs with data available back to the beginning of 2008. These CEFs are

included in both the Long Term Income portfolio and the Short Term Income Portfolio. The chart below shows the average discount for these seven CEFs at the end of each month. The chart shows that discounts last bottomed at 13% in September 2015 and then climbed back to 5.8% as of 9/30/17. This "tailwind" resulted in 2 year returns of greater than 30%. Since then discounts have reversed lower, putting a drag on returns. This is the main reason for the loss in the prior year. In the current year discounts widened further but only .4% compared to the prior year. Thus discount changes had a much smaller negative impact for the current year returns than in the previous year.

The chart shows that discounts greater than 10% are unusual. Over time these discounts tend to revert towards the mean, but the short term impact on mark-to-market account values can be disconcerting. When investing in this strategy it is important to keep in mind that the long term returns for which we are investing come primarily from dividends and so I urge you to focus on these cash flows in deciding if you can fund your retirement rather than the emotional rollercoaster that we see in short term fluctuations in discounts and spreads.



As of 9/30/19 the average discount is at 10.3%. This is a bit larger than normal but it is not yet a bargain given the current market environment.

Bonds produce pleasing capital gains as interest rates decline but this also means lower expected future returns on the now higher values. Thus we should not expect future returns to continue at their recent pace in the near term (though anything is possible). As of 9/30/19, the yield on the Long Term Income Portfolio is 7.5% (before fees). This seems to be a reasonable return for the risks.

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A Primer for Buying Long-Term Care Insurance

Long-term care insurance provides benefit payments to offset the costs of care providers that help us when we cannot do everything by ourselves any more. We all hope we'll never need such care, but if we do, the costs can be large. The costs of such care depend upon where it is delivered both geographically and the setting: home care, assisted living facility, or nursing home. Here are some monthly costs in 2018 from the Genworth Financial national survey:

Geography: Setting:	S.F. Bay Area	U.S. median	Texas median	Florida median
Home Health Aide	5,625	4,195	3,813	3,909
Assisted Living Facility	5,500	4,000	3,795	3,500
Nursing Home Semi-Private room	9,148	7,441	4,798	8,152
Nursing Home Private Room	11,650	8,365	6,540	9,064

According to the U.S. Department of Health and Human Services the average length of time needing long term care is 2.2 years for men and 3.7 years for women.

There are a lot of things to consider in deciding to buy long term care insurance. This article is only a starting point. The goal here is that you understand when you should buy this insurance and a framework for knowing what to look for in the insurance marketplace. We'll cover government programs for those without insurance and the implications for married couples, timing the purchase of long term care insurance, types of policies, key variables for choosing a policy, and related tax issues.

The Government Backstop – Medicaid and Medi-Cal

Long term care insurance is expensive, the benefits are far in the future, and many people will not want to buy it. If you end up needing care and you don't have assets to pay, government programs may pay for your care. In California we have the Medi-Cal program; nationally there is the federal Medicaid program. Eligibility for these programs depends on your health and they are means tested. With certain exceptions, you will need to spend your assets down to $2,000 to qualify. If you are not married and you don't care to leave an inheritance, it may make sense to forego insurance and rely on the government. If you don't buy insurance and you want to avoid depleting assets of your spouse or heirs you'll need to hire an attorney specializing in the complexities of government rules to determine if there is a way to preserve some assets.

Shopping for Long Term Care Insurance – Start Early

If you want to protect your assets from the potential costs of long term care (or you don't want to rely on a government program) you should consider buying insurance before you turn 40 or as soon afterward as possible. This means you're likely to be paying premiums for a very long time before using the insurance. There are two reasons to do this:

1. Insurance companies will assess your health in deciding whether to sell you a policy and how much to charge - so you need to apply while you have good health.
2. Premiums will be much more affordable if you purchase when you are younger.

When shopping for long term care insurance there are some terms you'll need to understand. The state regulates these policies and therefore you will see many common provisions across policies. For example a disability that qualifies for long term care benefits is defined by the inability to perform two or more of the six defined activities of daily living[1]. You also qualify if you require supervision because of severe cognitive impairment (e.g. Alzheimer's). The government also requires that these policies are guaranteed renewable. Once you have insurance they cannot cancel or raise premiums because of your health.

The policy elimination period is the period during which you are qualified for benefits under the policy but no benefits are due. It functions like the deductible for car insurance: the customer pays the first loss before the insurance kicks in. The elimination period is typically 30 or 90 days. Often there is a waiver of the elimination period if the client is getting home care.

Insurance policies can offer differing benefits depending on the category. Nursing home care is most expensive so that is where the maximum monthly benefit limit would be in effect. There can also be separate monthly benefits for an assisted living facility and for home care. All limits could be the same but not necessarily. There is also the possibility for cash benefits under a lower limit where you don't have to submit billing documentation. This may be useful if you decide to get care outside the U.S. Most policies will limit the other benefit categories to no longer than 12 months (sometimes less) if you are outside the U.S.

Protection Against Inflation is Crucial

Given the potential for benefits to be paid 20 to 40 years after the policy is written, it is imperative to have an inflation protection provision in the contract. These are often done as a contract add-on called a "rider". Although these are referred to as inflation protection, they are not actually tied to the rise in prices. Typically you specify a fixed percentage rate at which you want your benefits to rise and how long they will so escalate. Then you pay a premium according to this choice: the higher the escalation, the higher the premium. Assuming you choose a benefit level in line with today's costs, I recommend choosing an escalation rate of at least 3%. Some policies also allow a later buy up premium adjustment to raise the escalation rate in case inflation is higher than expected. But that premium will be set at the time you bump up the escalation rate.

Another frequently included term says that the premiums are waived once you are being paid benefits. This is important because you won't want pay premium costs on top of the costs of care.

[1] Bathing, continence, dressing, eating, toileting, transferring.

Traditional Long Term Care Insurance Contracts

Traditional long term care insurance is characterized by a maximum lifetime benefit amount and premiums that continue until you start collecting benefits or you die. Also, the premiums can increase if the insurance company under-estimated total costs of providing such insurance at the aggregate level. Such increases would have to be approved by the state insurance commission and they cannot raise your premium because of your personal circumstances. Couples can buy policies with shared lifetime benefit limits such that part of the other person's limit can be used if your maximum limit is reached and there is available limit on your partner's policy. This feature can provide more favorable trade-offs between coverage and premiums than stand alone policies - but the catch is that each policy must have identical monthly and lifetime limits. Sometimes this will not make sense such as when health issues limit the policy choices of one person but not the other.

Hybrid Long Term Care Insurance and Life Insurance

Another type of policy is called Hybrid insurance because it combines life insurance with long term care insurance. These policies offer guaranteed fixed premiums and you can choose a limited payment schedule such as 10 or 20 years. That way there is a definite limit to the premiums you will pay. There are two components to a hybrid policy – the life insurance pool of money which can be "accelerated" to pay monthly long term care costs, and a "continuation of benefits" provision (a policy rider) that can provide unlimited long term care payments after the policy holder has used up the life insurance pool on long term care. In these contracts the continuation of benefits is stated as a monthly benefit maximum that rises according to the escalation rate chosen up front. The life insurance pool money which must be used first is, however, not adjusted by the escalation rate. The result may be uninsured costs in the first few years of use until you work through the fixed pool of money and reach the continuation of benefits stage.

The hybrid structure is very appealing in that your premiums are limited and benefits are unlimited – the opposite of the traditional policy described earlier. The disadvantage is that you will need to set aside money for "self insurance" when you are receiving the un-inflated benefits from the life insurance pool amount. Another disadvantage is that you will most likely pay higher total premiums for this type of insurance.

Hybrid contracts also can be structured so that a couple shares the life insurance pool money to be accelerated to pay for long term care. Once this is used up, they can both utilize the maximum monthly benefit under the continuation of benefits component – as adjusted for the escalation rate since inception of the contract.

Another important aspect of the life insurance component of a hybrid policy is that you can pay the full premium up front at a discounted rate. This portion of the premium won't be tax deductible anyway so it might make sense to prepay in certain circumstances. Note however that if one half of a couple dies, it does not eliminate the need to pay the premiums. If the premium is spread over many

years, you might need to buy life insurance to cover the deceased partner's portion of the premium that remains.

Not All Insurance Companies are Equally Good

There are also company specific factors to consider. In particular, you should evaluate the credit-worthiness of the insurance company. You want to make sure there is a high likelihood they'll still be in business when you need to collect benefits. An easy way to do this is to look at where they stand in the Comdex ranking report. This report combines ratings from A.M. Best, Standard and Poors, Moody's and Fitch. To get it, you'll have to ask for it from your insurance agent. You can find copies on the internet but they may not be up to date. Individual companies may add special exclusions that they could use to deny your benefits. Therefore you need to read these provisions carefully. In particular, if you have more than one policy watch out for clauses which effectively "coordinate benefits" - meaning payments from the policy could be reduced if you are receiving payments from some other source. Such terms might cause your total benefits to be less than your actual costs.

You also need to do some research on consumer complaints to figure out the character of the companies. I found this out the hard way when I filed a claim for my mother. The insurance company, Met Life, told me that the elimination period did not start when she first incurred costs but rather when they finished processing the claim paper work – which they never did. Buyer beware: not all companies process claims in the same way.

Tax Issues Related to Long Term Care Insurance

Given the high costs of these policies and the potentially large benefit payouts, tax treatment is important financially. Currently, benefit payments received are not taxable to the extent they reimburse costs. Deductibility of the premiums is a little more complicated. You can deduct the long term care insurance premiums as an itemized deduction if total unreimbursed medical expenses exceed 7.5% of adjusted gross income. This is not very helpful for most people. A better result is available if you are self employed or you own a profitable corporation or limited liability company. In that case premiums can be deducted from business income directly - up to the age-based limits imposed by the Internal Revenue Service. Here are the 2019 annual deduction limits by age of the insured:

Below age 41 - $ 420
Age 41 to 50 - $ 790
Age 51 to 60 - $1,580
Age 61 to 70 - $4,220
Over age 70 - $5,270

As mentioned previously, the portion of premiums attributable to the life insurance portion of a hybrid policy will be completely non-deductable.

The limitations shown in the previous paragraph mean that it will not make sense to pay a one-time premium for future long term care insurance. Only by

spreading the premiums out over enough years, can you maximize the related tax savings.

Most of us would rather not think about the potential financial implication of needing long term care, but neglecting this issue could be devastating to the lifestyle of a healthy spouse who becomes financially responsible for the costs. Dealing with this issue far in advance will result in lower costs and more choices of insurance. It will take some time and effort, but I hope this short primer is enough to ease your path to get this taken care of while it is still just an inconvenience.[2]

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[2] Berkeley Investment Advisors does not sell insurance.