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Investment Newsletter – September 2020

This newsletter starts with an introduction to our new Real Estate portfolio strategy. Following that is a discussion of a risk reduction approach to stock investing that is likely to earn superior returns over the long run. Then we wrap up with an update of the performance of the Long Term Income strategy as of September 2020.

Real Estate Portfolio Strategy Launch Announcement

The June 2020 newsletter explained the potential for rising inflation and provided a rationale for dedicating a portion of equity allocations to Real Estate Investment Trusts (REITs). Our new Real Estate portfolio was launched August 31st and 50% of monies previously in the Long Term Value equity strategy were reallocated to the Real Estate portfolio. At launch the portfolio was 60% in residential REITs, 26% in self-storage REITs, 7% in a multi-class REIT managed by the Berkshire Hathaway of real estate: Brookfield Properties. While the first two segments mentioned are primarily aimed at protection against inflation and downside risks, the Brookfield portion is meant to provide more upside during periods of low inflation. Currently the portfolio still has 7% cash to be invested opportunistically (in the near future). Currently this portfolio provides a dividend yield of a little over 4% and that income gets favorable tax treatment as Qualified Business Income. As explained in the June newsletter this portfolio should provide insurance against an inflationary environment and should have less downside risk compared to the overall market.

Reducing Risk to Increase Returns from Stock Investing: The Case for Defensive Equity

In 2020 we cannot expect to earn returns that even match inflation without taking investment risks. It was not always so. In my view this was an avoidable situation, but our leaders led us into this blind alley and it will be hard to find a way back. In the meantime we must endure much more risk in pursuit of decent investment returns than prior generations. Despite the academic theories of

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yesteryear, not all risks are justified by higher expected returns.¹ Over the last 20 years or so, general equity market risks have not been compensated by extra returns. From 1999 to 2019 the Vanguard Long-Term Bond Index Fund returned 272% versus 210% for the S&P 500 stock index. Part of the reason for this is that investors get very excited about the latest fad stocks and bid up their prices to unreasonable levels such that good long term returns are just not possible for these market darlings. Inevitably those popular stocks fall back towards more normal prices. We see the same situation today. This does not, however, mean that all stocks will offer inferior returns.

If we need to invest in stocks to earn higher returns than bonds can offer, we should be careful not to invest in portions of the stock market where the downside risks are high relative to expected returns. We must resist the “story” stocks and focus on “boring” stocks. There are two main reasons to focus on the lower risk stocks:

1. The larger the potential drop in portfolio value (i.e. “drawdown”), the more likely an investor will be unable to stick to the investment plan and thus sell low—locking in losses during a down market. They would be better off owning stocks that they can hold to the bottom and back up again.
2. Even if investors could stick it out holding riskier stocks, the low risk stocks tend to earn more in the long run because steadier returns compound into higher long term gains compared to stocks with huge up and down moves.

In late 2018 Berkeley Investment Advisors implemented a Defensive Equity strategy using a portfolio designed at Folio Institutional - where many of our client accounts are held. In order to illustrate the benefits of a risk reduced equity strategy, let’s look at this portfolio and its historical results. Here’s a summary of the portfolio characteristics:

count	Weighting	Sector
14	36%	Consumer Non-Cyclicals (Staples)
9	25%	Healthcare
2	6%	Consumer Cyclicals (Discretionary)
3	9%	Industrials
5	13%	Utilities
1	3%	Consumer Services
1	3%	Business Services
2	5%	Telecommunications
1	3%	Technology
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38	100%	

The average company size is \$96 billion. The average stock in this portfolio has lower price volatility than 92% of other stocks. The average sensitivity to market moves (known as its Beta) is .82. This means that if the market drops 1% we would expect this portfolio to drop .82%. Note the high weightings for the traditional defensive sectors: consumer staples, healthcare, and utilities. In the

¹ Meaning the probability weighted return over the full range of potential future outcomes.

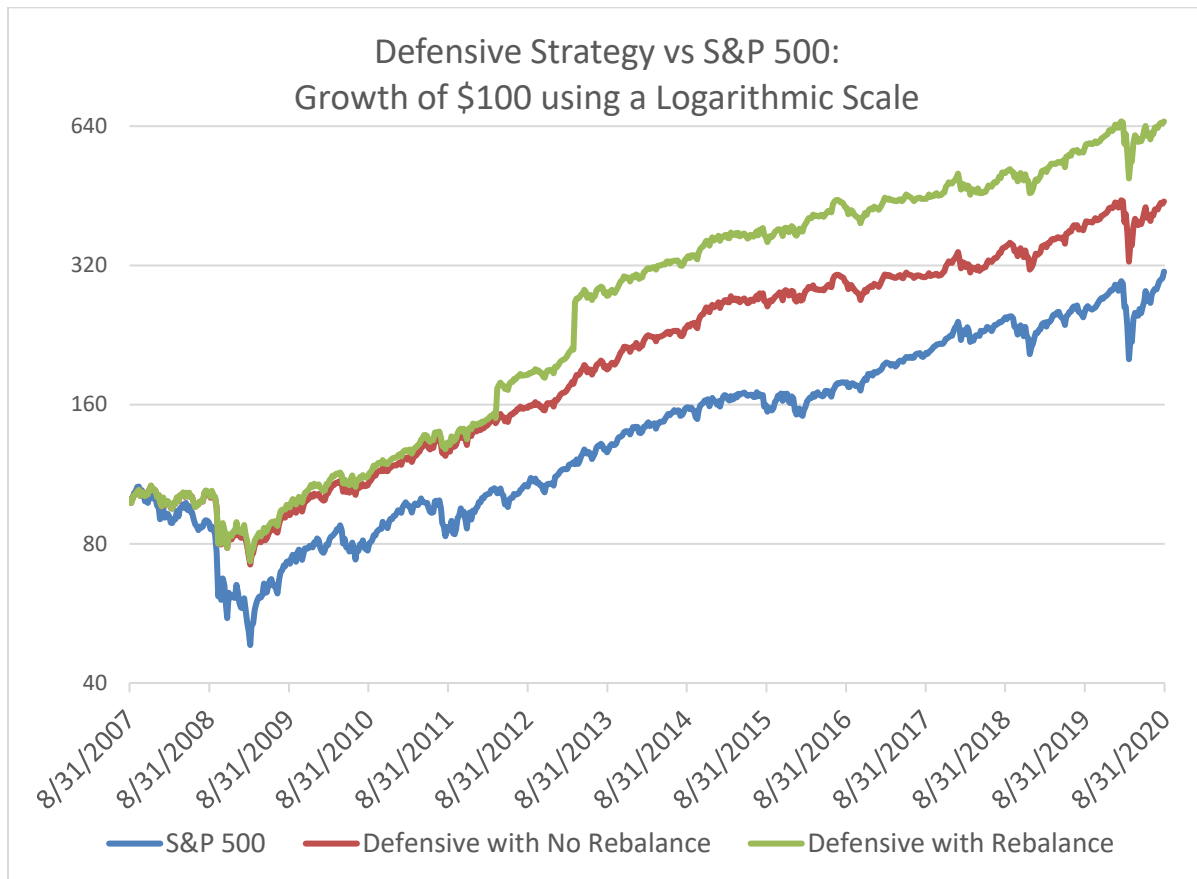
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June 2020 newsletter we saw that the consumer staples sector is not only lower risk, but has the highest returns of any sector from 1974 to 2019.

Although we only invested in this strategy starting in 2018, I've done an analysis of returns for this portfolio all the way back to 8/31/2007. That was just before the peak prior to the financial crisis. This is important because we want to evaluate performance across both of the recent down and up cycles in the market so as to get a true picture of risks and long run returns, and because the earlier decline was much more typical than 2020. In order to do the return calculations I've looked at two possibilities:

1. No rebalancing – whatever shares we buy at 8/31/2007 are held until the end which is 8/31/2020.
2. Rebalance – meaning buy and sell every week (because I'm using weekly data) to bring the portfolio back to the original weightings at the start.

Note that it is very unlikely we would ever actually do such frequent rebalancing but this assumption helps illustrate the magnitude of potential benefits to rebalancing at some frequency. The graph below shows returns versus the S&P 500.



As the graph shows, the Defensive Strategy portfolio suffers smaller declines and produces better returns than the overall market as represented by the S&P 500 index of large capitalization stocks. In the real world (as opposed to academic studies) the key risk measure we care about is the drop in portfolio value from its most recent high. This is called drawdown risk. This is what causes investors to

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destroy their retirement savings by getting out after their portfolio has dropped to a low.

Here is a table summarizing the key results of the chart on the prior page:

	S&P 500	Defensive with No Rebalance	Defensive with Rebalance
2009 Maximum Drawdown	-52%	-28%	-27%
2020 Maximum Drawdown	-32%	-26%	-25%
Cumulative Return for 13 years	210%	340%	555%
Annualized Returns	9.1%	12.1%	15.6%

Note that the Defensive Portfolio had a much bigger difference in drawdown during the 2009 recession than this year. This is because the nature of the 2020 economic shutdown had a much lesser impact on the highly cyclical technology sector than in a normal recession. We should not expect this to necessarily repeat in a typical recession.

Also please note that the cumulative return differences here greatly favor the lower risk Defensive Equity strategy! Of course, past results do not guarantee future returns so we must always be on guard for strategies that become too popular for their own good. Fortunately these stocks are just too boring for the majority of investors (which is good for us).

The above results are good, but given that the current portfolio includes a few riskier positions, perhaps we can improve it.

Improving Defensive Equity

Looking at the individual stocks in the Folio Institutional portfolio, there are 8 stocks that have Beta greater than 1—meaning they tend to move by a larger amount than the market as a whole. Looking at these stocks' individual drawdowns during the March selloff, they were large relative to the rest of the portfolio. In order to test my hypothesis that we can improve results by eliminating higher risk stocks from the existing portfolio, I did another performance analysis in which I removed these positions from the portfolio and redistributed the weighting (i.e. investment) proportionately to the remaining 30 stocks. Again, I calculated returns with and without rebalancing. In the table below I've compared this Low Beta version side by side with the original portfolio for both the no rebalance scenario and the weekly rebalancing assumption.

	Defensive with No Rebalance		Defensive with Rebalance	
	Original	Low Beta Version	Original	Low Beta Version
2009 Maximum Drawdown	-28%	-26%	-27%	-25%
2020 Maximum Drawdown	-26%	-22%	-25%	-20%
Cumulative Return for 13 years	340%	328%	555%	606%
Annualized Returns	12.1%	11.8%	15.6%	16.2%

In all cases the Low Beta version reduces the drawdown risk, but in the case of no rebalancing this lower risk version has slightly lower returns. On the other hand the lower risk portfolio has slightly higher returns if we did weekly rebalancing.

This exercise was just an experiment to determine how further reducing risk might impact returns. This very simple strategy adjustment indicates that there may be room to further decrease risk and/or increase expected returns. This will be my project in the 4th quarter.

Long Term Income Portfolio Strategy and Performance

The year ended 9/30/2020 produced a 3% loss in the portfolio. The return for the year, measured after fees, fell significantly short of the bond index that serves as the comparison benchmark for the portfolio (as discussed below). The main reason for this poor performance was the large shift in bond market risk pricing. This makes sense as the recession and lock downs will cause higher levels of bond defaults. Our strategy is to accept these risks so as to earn the higher returns in the long run that go along with the risks. The flip side is that the lower prices today imply higher returns going forward as our reward for bearing the risk. Of course there is no guarantees we will outperform going forward, but it does seem likely. 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 6.4 but it was 4.3 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.

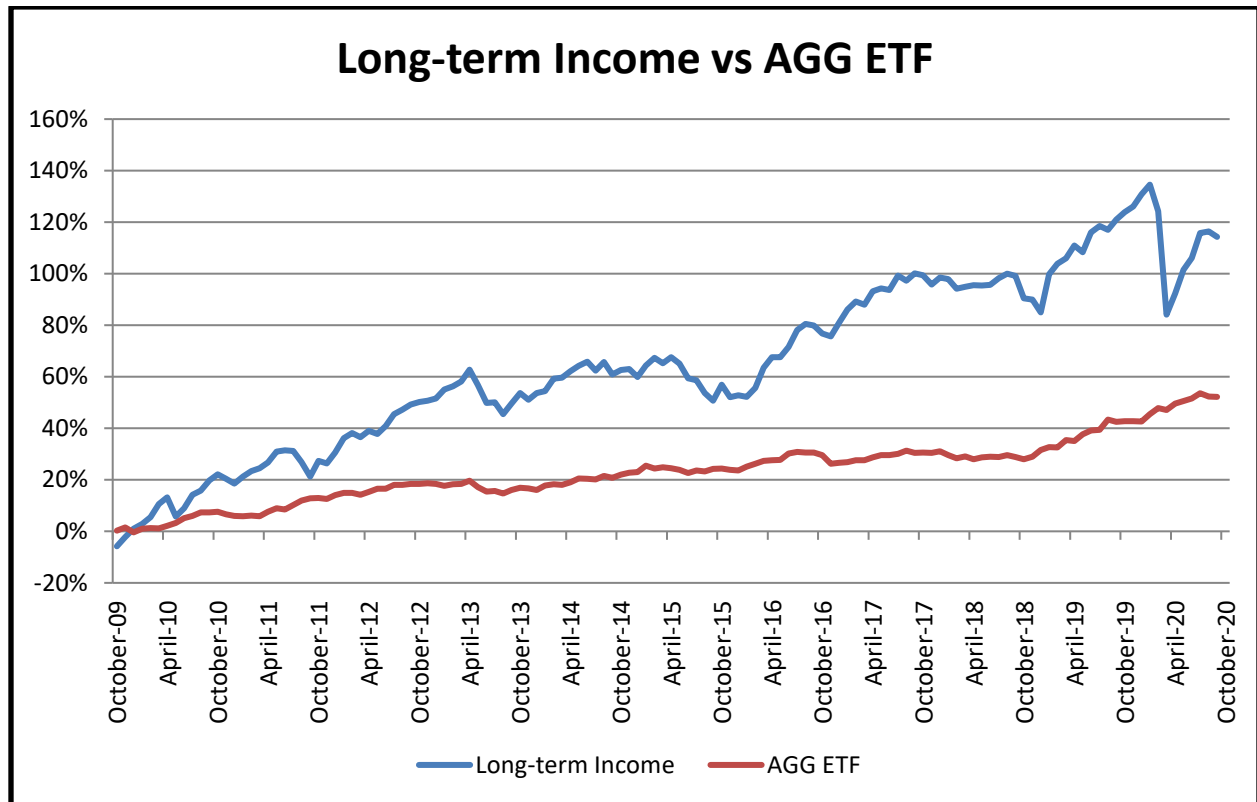
We also earn incremental yield by buying closed-end funds (CEFs). These securities can be bought at discounts to the underlying bond values (and occasionally sold at a premium). These funds also enhance returns through

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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 1.07% 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 eleven years. The graph and 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 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.

As shown in the table on the next page, total return over ten years is 114.3% - an annualized compound rate of return of 7.92%. The table 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

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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.

Returns by Year				
Year	Year Ended	Long Term Income	AGG Bond Index	Difference
1	9/30/2010	19.8%	7.4%	12.4%
2	9/30/2011	1.2%	5.0%	-3.8%
3	9/30/2012	23.1%	5.0%	18.1%
4	9/30/2013	0.2%	-2.0%	2.3%
5	9/30/2014	7.6%	4.1%	3.5%
6	9/30/2015	-6.4%	2.9%	-9.3%
7	9/30/2016	19.4%	5.2%	14.2%
8	9/30/2017	11.3%	-0.1%	11.4%
9	9/30/2018	-0.5%	-1.3%	0.8%
10	9/30/2019	10.9%	10.6%	0.3%
11	9/30/2020	-3.0%	6.8%	-9.9%
Compounded Total		114.3%	52.2%	62.1%

For the year ended 9/30/2020 the interest rate on 10-year treasury bonds decreased from 1.67% to 0.68%. I estimate that this interest rate decline increased the market value of the portfolio by around 5.25% compared to last year (5.3 average duration times the 0.99% interest rate decrease). Remember our portfolio value moves in the opposite direction of interest rates.

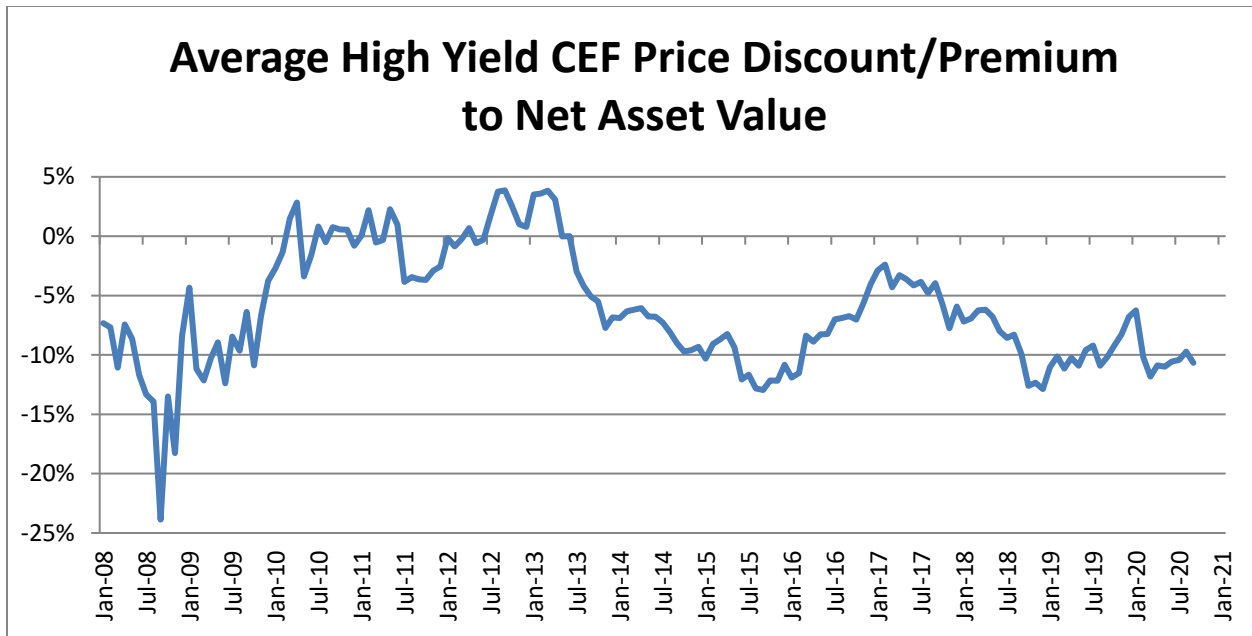
Credit risk spreads increased by 1.48% over the year to 5.50%, which reduced returns on a mark-to-market basis for the underlying bond net asset values (NAVs). This offset the positive effect of lower treasury rates, creating a 7.84% headwind for overall returns. We frequently see spreads increasing 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 lower than average levels at 9/30/20.

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 a slightly tighter than normal level 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. In the current year

discounts fluctuated substantially during the market turmoil but ended up only .5% higher compared to the prior year. Thus discount changes had a small negative impact for the current year.

The chart shows that discounts greater than 10% are somewhat 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 9/30/20 the average discount shown on the chart is at 10.7%. This is a bit larger than normal as we should expect given the current level of uncertainty.

When the pandemic hit the U.S. in March, it triggered extreme volatility in financial markets and liquidity (the ability to buy and sell securities) in bond markets evaporated. This in turn caused panic among CEF investors who tried to sell when there were few buyers and prices crashed. In order to put a floor on the portfolio and protect against our own investors panicking, Berkeley Investment Advisors implemented hedging trades in the long term income portfolio. When the Federal Reserve stepped in to become a big buyer in the bond markets there was a huge reversal in market psychology and the net result was losses on the hedge positions. Without these hedging costs the portfolio would have shown a small gain for the year.

While there is much risk in the current environment, higher than average CEF discounts imply that we should expect above average returns going forward from here (though anything is possible). As of 9/30/20, the yield on the Long Term Income Portfolio is 7.8% (before fees). This seems to be a reasonable return for the risks.

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