Berkeley Investment Advisors

Wall Street Expertise Working For You

Licensed by the California Department of Corporations as an Investment Advisor

Investment Newsletter – June 2021

Inflation has hit the headlines but there is much uncertainty about what comes next. We'll start the newsletter with a look at the possibilities and the implications for investing. This section also gives a quick update on the surprisingly good results for our inflation hedging real estate portfolio. We follow that up with the related and timely topic of a new real estate market investing opportunity created by the Covid pandemic: the roving remote worker rental market.

Inflation's Rising Impact on Investing Strategies

Last June's newsletter included an article titled "The Potential for Inflation" in which I explained that the stage had been set for increasing inflation and the political forces likely to sustain it. Today we can observe the first stage of this process in the data: the consumer price index increased 5% from 1 year ago in May. The Federal Reserve Bank claims they see this as a temporary spike that will subside by next year. I say claims because even if they believed it to be not temporary, their optimal strategy to increase employment and inflation would be to keep interest rates low by convincing the market that inflation would not be a problem. My view is this: even if they genuinely believe now that they will keep inflation under control at a low level, the political pressure to increase spending and inflation will prevent action down the road to slow inflation. But since no one knows exactly how this will play out, investors need to weigh the chances of the various possible scenarios and invest accordingly.

Rising inflation significantly changes the risks of holding normally low risk assets such as cash and long maturity investment grade bonds. Over the 10 years ended in December 2020 the consumer price index rose at a rate of 1.7% per year. If you were holding a cash balance for the entire 10 years you would have lost less than 16% of your purchasing power. Over a 3 year period you were losing only about 5%. Now suppose the 5% rate observed in May persists for the next 10 years. In that case your purchasing power declines about 14% over 3 years and 39% over 10 years. Thus the downside of cash holdings is much more significant to your retirement plans. Investment grade bonds in the current market environment pay interest at such low levels that they lose almost as much value as cash. They also have much more market risk because if the Federal Reserve ever decides to push rates above the inflation rate, that rise in rates would reduce long maturity fixed rate bonds' market values.

Tax exempt municipal bonds are a special situation. These are typically long term investment grade bonds with relatively low yields. The negative factors above apply, but there is a mitigating factor. The same political environment that is driving the increased government spending, (which is driving inflation) will also likely lead to higher tax rates which will increase the attractiveness of tax exempt bonds. Therefore this type of bond has some offsetting benefits for investors.

Scenarios to Consider in Determining Investment Strategy

For purposes of analysis, we can look at 3 scenarios:

1. Inflation stays high but the Federal Reserve continues to suppress interest rates to inflate away the value of government debt.
2. Inflation subsides back to the Fed's 2% target on its own with no need for the Fed to raise rates above inflation.
3. The Fed raises rates above the inflation rate enough to push inflation back down to the 2% target.

The following table summarizes these possibilities.

	Scenario 1	Scenario 2	Scenario 3
Inflation Path:	Stays High	Slowly back to 2% without Fed action	High then Forced back to 2% by Fed
Interest Rates:	Stay Low	Stay Low or Small Increase	Low and then Large Increase

For scenario 1, the main risk to investors is that inflation erodes purchasing power. In this case we need an asset that performs well in a high inflation low interest rate environment. As I pointed out last June, Real Estate under shorter term leases will work well. Commodities such as gold or energy could also perform well but these entail more risks. High yield bonds and loans are also viable in such an environment since inflation will tend to reduce credit risk; also, much of the high yield market is related to energy. Other equity sectors are unlikely to produce returns much higher than inflation.

Scenario 2 is essentially a return to the status quo of the recent past. In this case fixed income strategies will perform well and especially longer maturity bonds paying higher yields. This scenario is neutral for the Real Estate strategy I've described as well as the other sectors of the equity market. There is still significant risk for most sectors because of the historically high valuations today.

Scenario 3 is a very adverse scenario for investors generally. Equities will do poorly in a rapidly rising interest rate situation. Within equities, our Defensive Equity portfolio will be the safest. Longer maturity fixed income will also be marked down in value by the market in this case though it should outperform stocks. The best place for investors to have their money in this scenario is short term income funds which have very little interest rate risk. Our Short Term Income strategy is designed for this case. Its returns should rise as the Fed raises rates.

Given that we can only assess the probabilities of these three scenarios, our investment allocations should reflect both our risk tolerances for the three situations and our assessments of the likelihood of each. This is why we created the Real Estate Inflation Protection strategy last August. As the probability of scenario 1 has increased, we have pushed up our allocations of assets to this portfolio for those clients with adequate risk tolerance.

So far the Real Estate portfolio has performed much better than expected. From inception 8/28/2020 to 6/30/2021 this portfolio has returned approximately 43% before fees. I attribute this to market participant's growing realization that scenario 1 is becoming increasingly likely to play out. Even so, if we are destined for scenario 1, this portfolio has further to run in protecting our retirement assets.

Rootless Renters - The Remote Work Rental Market Creates A New Real Estate Opportunity

The Covid pandemic has changed many things, especially real estate markets. At least one positive thing came from the pandemic: an acceptance by corporate America that employees can be productive working from home. Suddenly a great many office workers have discovered they like the freedom and flexibility of not working in an office and they love all the time they get back for their personal life when they don't have to commute. Many have taken advantage of this new life style to uproot themselves and explore other areas and modes of living.

This new found freedom of location has upended dense urban markets like San Francisco and New York as workers moved out to suburbs and the countryside for more room, lower costs, and a nicer environment. Rents have declined in San Francisco and house prices have shot up almost everywhere outside the big cities. We are also seeing huge growth in demand for a once niche market: furnished "temporary" rentals with lease terms longer than 30 days but shorter than the traditional one year residential lease. The Wall Street Journal described this phenomenon as "Nomadland for luxury-seeking remote employees" in a reference to the recent Van-Life movie. For purposes of this newsletter, I'll call this the nomad rental market.

The Wall Street Journal interviewed a couple with two children who realized this was their chance to explore where they might like to live. They started by moving from Las Vegas to check out Austin and Dallas in succession. Once they got started, they just kept going. Over the next year they lived 4-6 weeks at a time in seven different cities across the Southwest and Pacific Northwest. They had kept their household furnishing in storage but eventually they decided they enjoyed the new lifestyle and sold the things they no longer needed when moving around among furnished units.

Closer to home, a couple I know who lived in San Francisco at the start of the pandemic are on a similar adventure. So far they've tried out:

Austin, Houston, New Orleans, Memphis, Nashville, Ramer AL, Miramar FL, Tallahassee, St. Petersburg, Key Biscayne, Miami, Orlando, Jacksonville, Savannah, Atlanta, Knoxville TN, Louisville KY, St. Louis MO, Kansas City MO, Omaha NE, Sioux Falls SD, Grand Rapids WY, Gillette, WY, Salt Lake City UT.

Obviously they like the South. I suppose the fact that Florida has no income tax also made it an attractive place to work.

This new class of renters means that investors have another way to earn premium rental rates besides the short term vacation rental market. The couple mentioned above estimated that they were paying on average, about a 60% premium above prevailing rental rates for the convenience of coming and going as they like without lugging a household of furniture along. When looking for a place to move to, they have a list of must-haves that includes fast reliable internet service, a work area other than the bedroom so each person has some space, a premium coffee machine (or espresso machine), and a TV set up for streaming (not cable). They are also traveling with 2 dogs, so dog friendly places are required, and a yard is highly desirable. Other important amenities are high quality finishes for kitchens and bathrooms. To find the next place, they put their criteria into Airbnb, along with their budget, and search for desirable locations within a day's drive. Before vaccinations were widely available, they could search fairly close to the planned departure date. Now, however, since most people are vaccinated, they find that they need to reserve two months ahead of time. Waiting longer reduces the choices and increases the costs substantially.

The highest rents are available to you if you have a property with the above amenities in a desirable location that can be rented by the day, but this is not always an option. Many local jurisdictions have prohibited vacation rentals outright, (for example San Leandro) while others have severely restricted such opportunities. In Sonoma County there is a cap on new rental licenses in the West county area around Russian River and there are moratoriums on new vacation rental licenses in the various designated areas affected by fires in recent years. In addition they allow neighborhoods to enact their own prohibitions on such rentals.

On the other hand, rentals of more than 30 days are not regulated as vacation rentals, yet work from home professionals are willing to pay a premium for the convenience of furnished houses that don't require 6 or 12 month commitments. Of course, there is always some possibility for converting to a vacation rental if prohibitions are relaxed. With that in mind, I will illustrate the investing economics with a couple of cases based on recent property sales.

First let's look at a potential AirBnB rental property in Vallejo CA. As an example, 16 Sandy Beach Road in Vallejo sold for $950,000 on 4/5/21. This is a waterfront property not far from the ferry to San Francisco. This would be a great vacation rental thanks to the convenience of the ferry and the nearby Napa wine country. Judging by the pictures at Exhibit I, it is a spectacular property. This is two bedroom, two bath, with 3,162 square feet. A two bedroom property on the same street with similar view can be found on Airbnb with a title of "Waterfront Bliss". Its daily rate is $300. That property looks to be smaller and not as well located as 16 Sandy Beach. If we marketed this at $330 per night and achieved 75% occupancy, annual revenue would be $89,100. Investing in this property would require a 20% down payment, plus $25,000 for furniture and fixtures, and $5,000 in working capital. My analysis at Exhibit II shows that this would earn a slightly positive cash flow in year one (after adding back reserves for future capital expenditures). Over time it is likely that net operating income would grow with inflation, and since mortgage payments are fixed, this would imply a rapid buildup in net cash flow (and equity).

Similarly a three bedroom, two bath house on the waterfront a bit further away at 376 Seawind Drive in Vallejo sold recently for $880,000. It is slightly further from the Ferry, but still only a $15 Uber ride away (even with the current shortage of drivers). Given the extra bedroom, it might even rent for higher than the Sandy Beach house. The lower price and a lesser area to furnish would likely mean higher returns to the investor.

Next we shift our attention to Sonoma where vacation rental restrictions require us to rent property for more than 30 days at a time. Thus we would target the luxury nomad renter market. I've spoken with several of the property management companies up there that specialize in luxury furnished rentals for the vacation and nomad markets. The CEO of "The Wine Stay", Mike Little, gave several examples of the rents he gets for properties with the right amenities. A two bedroom house with a 1 bedroom guest cottage on a small lot in Healdsburg rents for $6,500 per month from spring to fall and $5,250 per month in the winter. He said this property is rented consistently every month. Currently it is fully booked to the end of October. Mr. Little further explained the value of certain amenities:

"If you had 2-3 outdoor spaces that have a fire pit/seating area, outdoor dining area with shade and maybe a bocce ball court, it could add an average of around $2,000-$3,000 a month. And in some instances more."

If you want to learn more about optimizing design and amenities for this market, Netflix has a television series called "Stay Here" in which they transform mediocre rentals into high-end destinations.

In my calls to other property managers in Sonoma they all indicated that demand exceeds supply so that everything is generally booked up if priced appropriately.

For our Sonoma rental example we will again look at a recent sale: two houses on .72 acres at 3990 Chanate Road in Santa Rosa sold for $800,000 in April this year. This is a gated property. Each house is two bedrooms, two baths. Exhibit III shows the listing pictures. A search on Airbnb for two bedroom rentals of more than 30 days gave results generally in the range of $3,800 to $7,000 per month. Based on this, I analyzed the two houses using a rent of $4,000 per month for each one. Assuming a 15% vacancy factor yields annual revenue of $81,600. As in the Vallejo example, I assume a 20% down payment and $5,000 in working capital, but since there are two houses, my estimate for furnishings and fixtures rises to $40,000. My full analysis at Exhibit IV shows the cash-yield on cash invested as 4.4% after adding back reserves for future capital expenditures. The cash yield on investment is 2.6% after deducting the reserves. This property should be solidly profitable and will probably do a bit better than the Vallejo example above. This is because the sales price relative to rental value was on the high side for the Vallejo property in comparison to the bargain of buying two houses on one lot in the wine country.

Now a couple of caveats. While buying conditions are currently favorable, prices are moving up and this may soon eliminate the high returns currently available. A sudden increase in mortgage rates would have the same effect. In terms of risks, the main one is a recession that reduces employment in the technology and finance sectors which drive a significant part of the demand described above. If you decide to invest in this new real estate opportunity, I recommend keeping a significant amount of money in reserve assets to cover holding costs during a down turn. Of course these reserves should be invested to avoid losing money to inflation but their purpose as reserves necessitates relatively conservative fixed income investments.

The Nomad Rental market is an interesting and potentially lucrative opportunity. If you choose to pursue it, I would be happy to represent you in your search.

Contact Information: RayMeadows@BerkeleyInvestment.com 510-367-3280

Exhibit I

16 Sandy Beach Road, Vallejo






Exhibit II

Vallejo view house Analysis - 1st Year

Property Address:	**16 Sandy Beach Rd., Vallejo CA 94590**				**Total Units:**	**1**
Asking Price:	$ 950,000	plus fixtures/furniture:		25,000	including 48K furniture	
Offer Price:	**$ 950,000**	**Gross Multiplier:**		**8.0**	Age:	33
Downpayment:	190,000	Cap Rate:		4.2%	Parking:	garage
Loans:	760,000	Cost Per Unit:	$	950,000	Master Meter:	no
Gross Income:	118,800	Price Per Sq Ft:	$	300.44	Closing Costs	19,544
Total Investment	239,544	Seller Paid closing			Working Capital	5,000

Annual Income and Expense

					Current Rent		Total
Daily Rate	**Number**	**Bedrooms**	**Baths**	**Sq Feet**	**Unit**	**per s.f.**	**Monthly**
330	1	2	2	3,162	9,900	3.13	9,900
Totals	1	2	2	3,162			9,900

Total Monthly Income		$ 9,900
Annual Scheduled Gross Income		$ 118,800
Less Rent Concessions		$ -
Less Vacancy & Credit Losses	**25.0%**	29,700
Effective Gross Income (EGI)		89,100

Expense Detail - Estimated

Property Tax	12,350	at	1.30%	of value +	spec as
Insurance	3,000	at	3,000	fixed +	per unit
Management	8,910	at	10.00%	of EGI +	
Repairs and Maintenance	3,162	at	1.00	per sq. ft.	
Utilities	4,200	at	350	per unit per month	
Water/Sewer, Garbg	1,800	at	150	per unit per month	
Supplies	4,800	at	400	per month	
commissions/fees	4,455	at	5%	of AirBNB rent	
	42,677	per unit =	42,677		
Reserves for Cap Exp.	6,324	at	2.00	per sq. ft.	
	49,001	per unit =	49,001		

Less Expenses @	55%	of EGI		49,001
Net Operating Income after reserves (NOI)				40,099
Less Loan Payments				40,953
Cash Flow (Pre-Tax)		-0.4%		(854)
Plus Principal Reduction				14,585
---->> Plus Expected Appreciation		1.8%		17,045
Total Return on Investment Before Taxes		**12.8%**	**$**	**30,776**
After Tax Return on Investment		**12.8%**	**$**	**30,776**

Cash Flow Return adding back reserves	
2.3%	**5,470**

Growth in NOI for yr 2:	3.0%
Increase in Cap Rate:	0.05%

Financing

		Amount	**Int Rate**	**Amort**	**Annual Payment**			
30 year fixed	$	760,000	3.50%	30	$	40,953	1st LTV =	80%
			6.00%	30	$	-	DSC* =	113%
	$	-	0%	-		-	Total LTV =	80%
		760,000	**Total**			40,953		

*Debt Service Coverage calculated using NOI + Cap Exp reserves

Comments

Rental rate and vacancy rate may be too conservative here. Lots of room to grow income.

Exhibit III

3990 Chanate Road, Santa Rosa




Exhibit IV

Santa Rosa Two House Analysis - 1st Year

Property Address:	**3990 Chanate, Santa Rosa 95404**				**Total Units:**	**2**
Asking Price:	$ 800,000	plus fixtures/furniture:		40,000	including 48K furniture	
Offer Price:	**$ 800,000**	**Gross Multiplier:**		**8.3**	Age:	64
Downpayment:	160,000	Cap Rate:		5.0%	Parking:	garage
Loans:	640,000	Cost Per Unit:	$	400,000	Master Meter:	no
Gross Income:	96,000	Price Per Sq Ft:	$	400.00	Closing Costs	16,918
Total Investment	221,918	Seller Paid closing			Working Capital	5,000

Annual Income and Expense

Daily Rate	Number	Bedrooms	Baths	Sq Feet	Current Rent Unit	Current Rent per s.f.	Total Monthly
	1	2	1	1,000	4,000	4.00	4,000
	1	2	1	1,000	4,000	4.00	4,000
Totals	2	4	2	2,000			8,000

Total Monthly Income		$ 8,000
Annual Scheduled Gross Income		$ 96,000
Less Rent Concessions		$ -
Less Vacancy & Credit Losses	**15.0%**	14,400
Effective Gross Income (EGI)		81,600

Expense Detail - Estimated

Property Tax	10,400	at	1.30%	of value +	spec as
Insurance	3,000	at	3,000	fixed +	per unit
Management	12,240	at	15.00%	of EGI +	
Repairs and Maintenance	2,000	at	1.00	per sq. ft.	
Utilities	6,000	at	250	per unit per month	
Water/Sewer, Garbg	2,400	at	100	per unit per month	
Supplies	1,200	at	100	per month	
commissions/fees	-	at			
	37,240	per unit =	18,620		
Reserves for Cap Exp.	4,000	at	2.00	per sq. ft.	
	41,240	per unit =	20,620		

Less Expenses @	51%	of EGI	41,240
Net Operating Income after reserves (NOI)			40,360
Less Loan Payments			34,487
Cash Flow (Pre-Tax)		2.6%	5,873
Plus Principal Reduction			12,282
---->> Plus Expected Appreciation		2.0%	15,914
Total Return on Investment Before Taxes		**15.4%**	**$ 34,069**
After Tax Return on Investment		**15.4%**	**$ 34,069**

Cash Flow Return adding back reserves	**4.4%**	**9,873**

Growth in NOI for yr 2:	3.0%
Increase in Cap Rate:	0.05%

Financing

	Amount	Int Rate	Amort	Annual Payment		
30 year fixed	$ 640,000	3.50%	30	$ 34,487	1st LTV =	80%
		6.00%	30	$ -	DSC* =	129%
	$ -	0%	-	-	Total LTV =	80%
	640,000	**Total**		34,487		

*Debt Service Coverage calculated using NOI + Cap Exp reserves

Comments

Rent estimate is probably conservative.

