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## **Investment Newsletter – September 2021**

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This newsletter starts with a discussion of the first year's results for the Real Estate portfolio strategy. Then we discuss interest rate moves and their impact on investors. We conclude with an update of the performance for the Long-Term Income strategy.

### **Real Estate Portfolio Strategy and Performance**

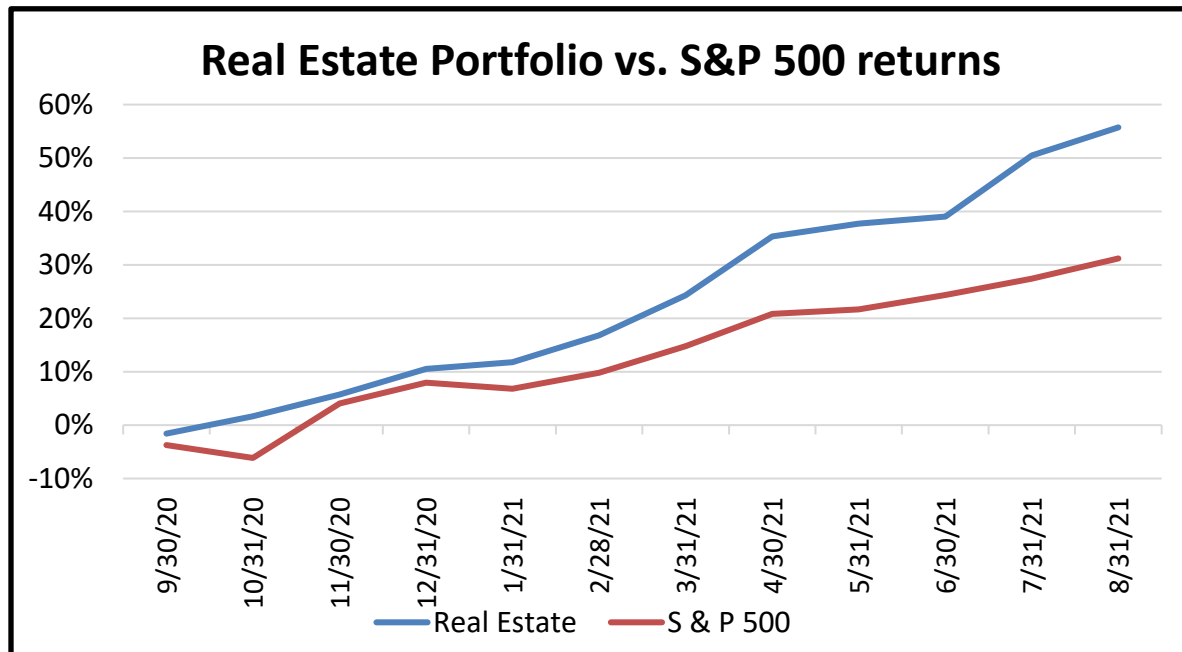
The June 2020 newsletter explained how the economic and political environment had changed to produce rising inflation. My analysis showed that by dedicating a portion of equity allocations to Real Estate Investment Trusts (REITs), investors could benefit from inflation rather than being hurt by it.

Our Real Estate portfolio was launched August 31<sup>st</sup> 2020 with 60% in residential REITs, 26% in self-storage REITs, and the remainder invested opportunistically in other real estate securities. Currently this portfolio provides a dividend yield of 2.7% and that income gets favorable tax treatment as Qualified Business Income. The goal of this portfolio is to provide insurance against an inflationary environment. Because REITs must pay out 90% of their taxable income, I expect it to have less downside risk compared to the overall market (where many stocks derive their value from investor sentiment about the distant future).

The results for the first year of this portfolio were spectacular. The total return, including dividends, capital gains, and price appreciation, was 55.7%. By comparison, the S&P 500 stock index returned 31.2% over the same period. Our results far exceeded my expectations for the first year. Given that inflation has indeed taken off, I attribute this rapid run up to the growing realization among other professional investors that inflation is indeed here and rising. When they look around for the best way to protect financial assets from the damage of inflation, they are concluding that REITs are an important component of a portfolio. The resulting rush to buy has accelerated the returns that I expected.

Currently the portfolio contains 66% residential REITs, 27% self-storage, 4% in homebuilding, and the rest in cash. Every position has done well and they are priced at high multiples of funds from operations. We can interpret this as the market anticipating much higher growth in rents and income going forward due to the impact of inflation. With the eviction moratorium ended, I think the market is correct in anticipating fast growth in rents and we are already seeing large increases in many markets away from the large coastal cities.

The graph below shows monthly cumulative returns for the first year in comparison to the S&P 500 stock index.



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 economic data confirmed my thesis about inflation, and consumer expectations for future inflation increased, I shifted more of risk tolerant clients' money from Long-Term Fixed Income to the Real Estate portfolio.

There is always risk in any investment strategy. For the Real Estate portfolio, the main risk is that the Federal Reserve (the Fed) moves to aggressively raise rates next year to fight inflation. By the time they wind down asset purchases and start raising rates, we will have plenty of time for inflation to subside if it turns out to be due to one-time issues, or plenty of time for higher inflation to become embedded in the economic system. If it's the first of these, rates will rise very slowly and should have little impact on the portfolio. If inflation is in high gear, the Fed would be faced with a tough choice: they have to raise interest rates to at least 2% above the inflation rate, or acquiesce to permanently higher inflation. We have not seen such a large interest rate rise in decades and we've never seen such a rate rise in the face of such a large government debt. My opinion is that it will be politically impossible for the Federal Reserve to raise rates that high given how much debt is being accumulated by the government. Thus, I see the risk of much higher rates as less likely than the risk of higher inflation.

### Further Thoughts on Interest Rate Moves

The 10-year Treasury Bond yield has risen .24% since the end of August. This is a significant upward move in rates. The 10-year rate is not directly controlled by the Federal Reserve bank. However, its movement is heavily influenced by market participants' expectations for changes in the short-term rate

controlled by the Fed. The Fed expects inflation to be transitory, and that they won't have to raise rates to combat inflation; they also claim that they will raise rates if needed to calm inflation if it is still high in mid-2022. My view is that they will not raise rates higher than the inflation rate; but that still leaves room to go above the current 10-year rate. Meanwhile technology stocks are priced as if rates will be 0 forever and thus, they react quite adversely to impending rate hikes. Rising rates (and inflation) will have varying impacts across different types of investments. Investment grade bonds will decline in price. High yield bonds may lose value but this will be partially offset by lower credit risks. Real estate will likely get a short term mark down, but over time the higher inflation (and thus cash flow) will more than offset the valuation hit.

### **Long-Term Income Portfolio Strategy and Performance**

In the year ended 9/30/2020 the Long-Term Income portfolio produced a rare loss thanks to the market turmoil caused by the Pandemic. It has bounced back to give us a 20.3% gain for the year ended 9/30/2021. The return for the year, measured after fees, significantly beat the bond index that serves as the comparison benchmark for the portfolio (as discussed below). Essentially the market has gone from doom and gloom to boom and zoom. The main reason for this great performance is the mirror opposite of the prior year: we had a large reversal in bond market risk pricing as investors embraced risk again as multiple stimulus packages eliminated the perceived economic downside. As I explained in last September's newsletter, the flip side of the lower prices at that time was expectation of higher returns going forward as our reward for bearing the risk. Note that this means we should not expect another return like this in the near term.

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 5.2 (it was 6.4 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.

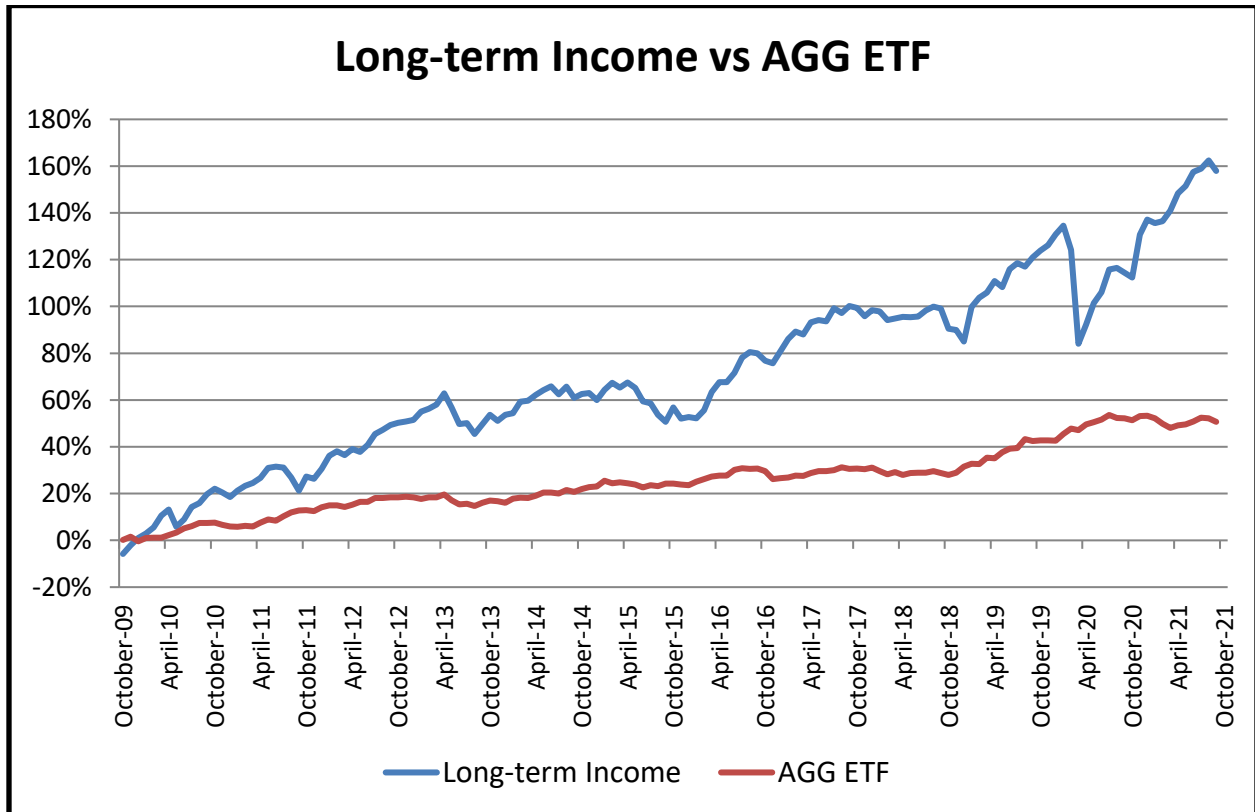
The extra return on high yield bonds over the interest rate paid by the U.S. treasury is called a credit spread – it is the compensation that investors demand for taking credit risks. These spreads change according to investors' risk preferences – i.e. how much they need to get paid for taking credit 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 .6% higher yield on our portfolio than if we held the underlying bonds directly.

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 that. 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).



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As shown in the table below, total return over twelve years is 158% - an annualized compound rate of return of 8.22%. 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 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.

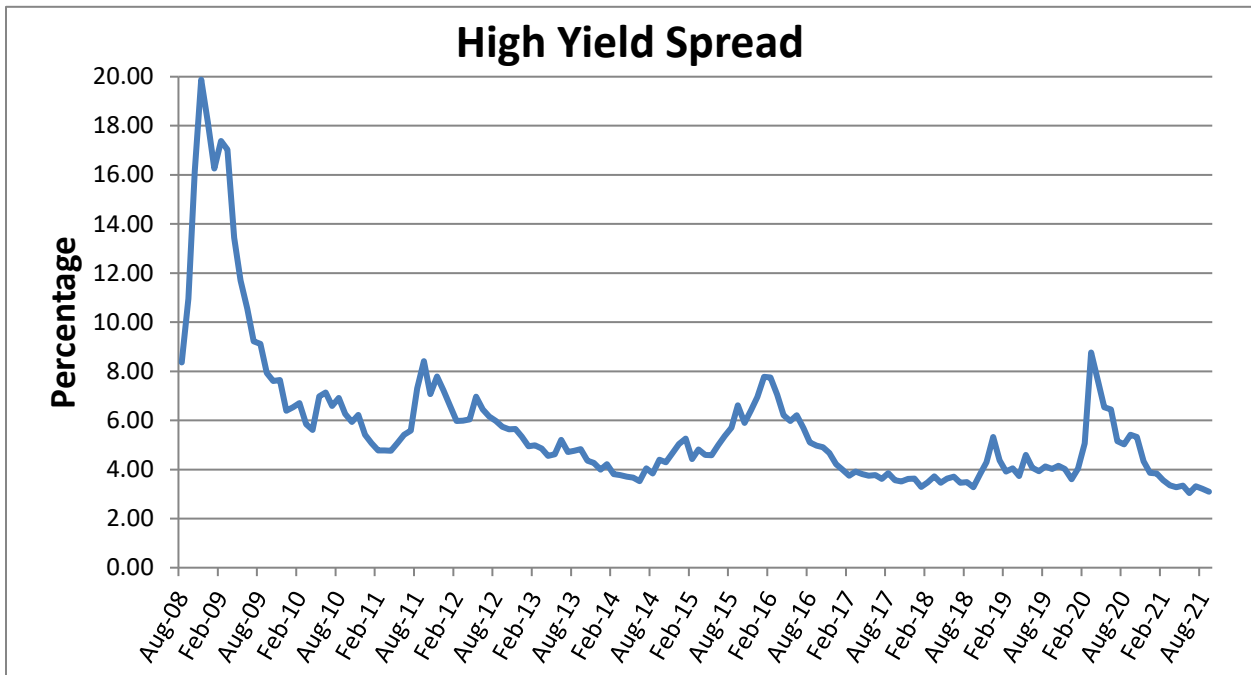
| Returns by Year  |            |                     |                   |            |
|------------------|------------|---------------------|-------------------|------------|
| Year             | Year Ended | Long-Term<br>Income | AGG Bond<br>Index | Difference |
| 1                | 9/30/2010  | 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  | -2.9%               | 6.8%              | -9.8%      |
| 12               | 9/30/2021  | 20.3%               | -1.0%             | 21.2%      |
| Compounded Total |            | 158.0%              | 50.7%             | 107.2%     |

For the year ended 9/30/2021 the interest rate on 10-year treasury bonds increased from 0.68% to 1.50%. I estimate that this interest rate increase decreased the market value of the portfolio by around 4.76% compared to last year (5.8 average duration times the 0.82% interest rate increase). Remember our portfolio value moves in the opposite direction of interest rates. Although the rise in interest rates reduced the mark-to-market value of the portfolio, higher rates will benefit us in the long run by increasing cash interest payments received as underlying bonds mature and are replaced with new higher coupon bonds.

The graph on the next page shows credit spreads starting the month before Lehman Brothers collapsed.

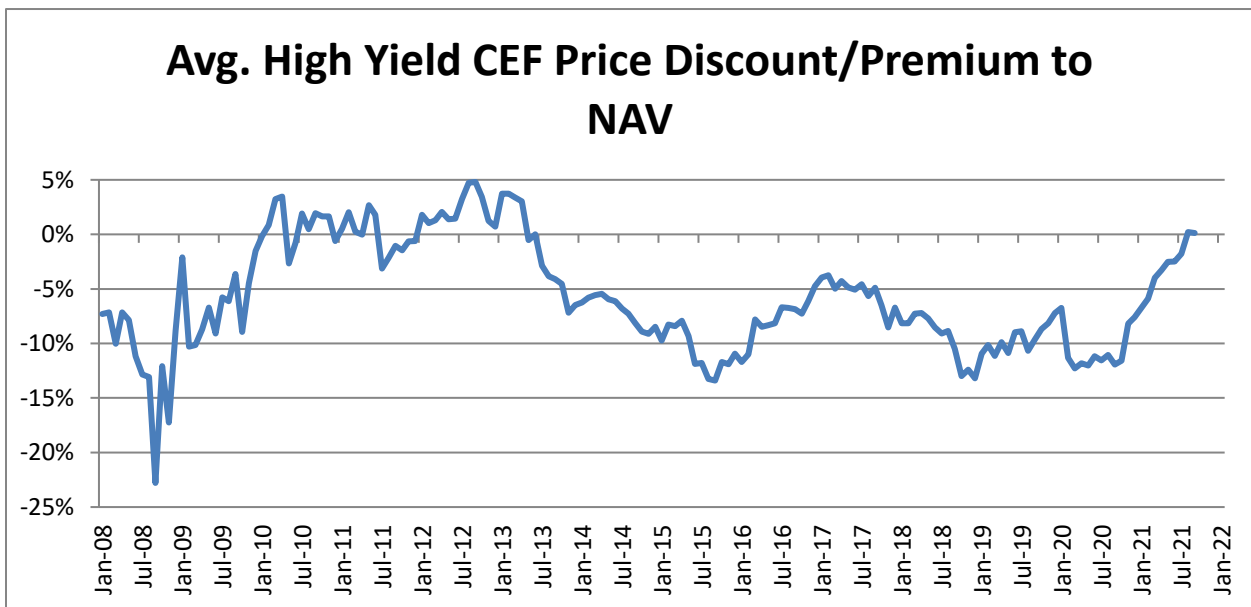
The median spread over this period is about 5% and spreads gyrate around this central tendency, driven by market sentiment. The current spread of 3.09% is 2.32% lower than last year and near the lowest point of the 13 years. This makes sense because when inflation rises above expectations it makes it easier to repay debt since the real value owed is reduced as prices rise. Therefore, inflation tends to reduce credit risk except for companies that cannot raise prices because of long-term contracts. Still, spreads are very unlikely to go much lower from here so we should not expect this source of appreciation to continue. I estimate that the decrease in credit spreads contributed approximately 8.2% to our return over the

year, more than offsetting the impact of rising interest rates. We generally see these two risk factors pushing in opposite directions.



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 8 CEFs with data available back to the beginning of 2008. See the graph below.



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These CEFs have been (and some currently are) included in either the Long-Term Income portfolio or the Short-Term Income Portfolio. The chart on the previous page shows the average discount for these eight CEFs at the end of each month. We see that discounts last bottomed at 12.3% in March 2020 and then climbed back to reach a slight premium at 8/31/2021. This is a very unusual and is likely to reverse over the next year. Our strategy is to reduce exposure to premium priced CEFs as prices run up. Over the year, the average discount declined 12%. I estimate this “tailwind” of declining discounts provided the Long-Term income portfolio roughly an extra 9% return for the year ended 9/30/21.

As of 9/30/21, the yield on the Long-Term Income Portfolio is 6.3% (before fees). The weighted average CEF discount of the portfolio is at 4%. As valuation metrics have increased over the year, we have reduced allocations to the portfolio. Still, investing is about probabilities which change incrementally and so our adjustments are also incremental. While there is less upside for the portfolio than last year, there are scenarios where we need this portfolio to balance other risks in clients’ allocations.

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