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Investment Newsletter – September 2023

Executive Summary

Rising real interest rates (rates in excess of inflation), along with declining inflation, caused very poor performance in the Real Estate Inflation Protection strategy. The Long-Term Income portfolio did much better, as it rebounded from the previous year, but with extreme volatility in its mark-to-market value. In the last few months, the economy has demonstrated resilience in the face of higher interest rates. The Federal Reserve has signaled that still higher rates are coming and that the much-anticipated rate reductions are not coming anytime soon. A prominent hedge fund manager has joined a few other market commentators in forecasting a permanent rise in interest rates. Recent economic data and policy clarifications indicate it is prudent to reduce exposure to the risk of higher real interest rates in the near term.

The Next Big Short – Bill Ackman's Bet Against Long Bonds

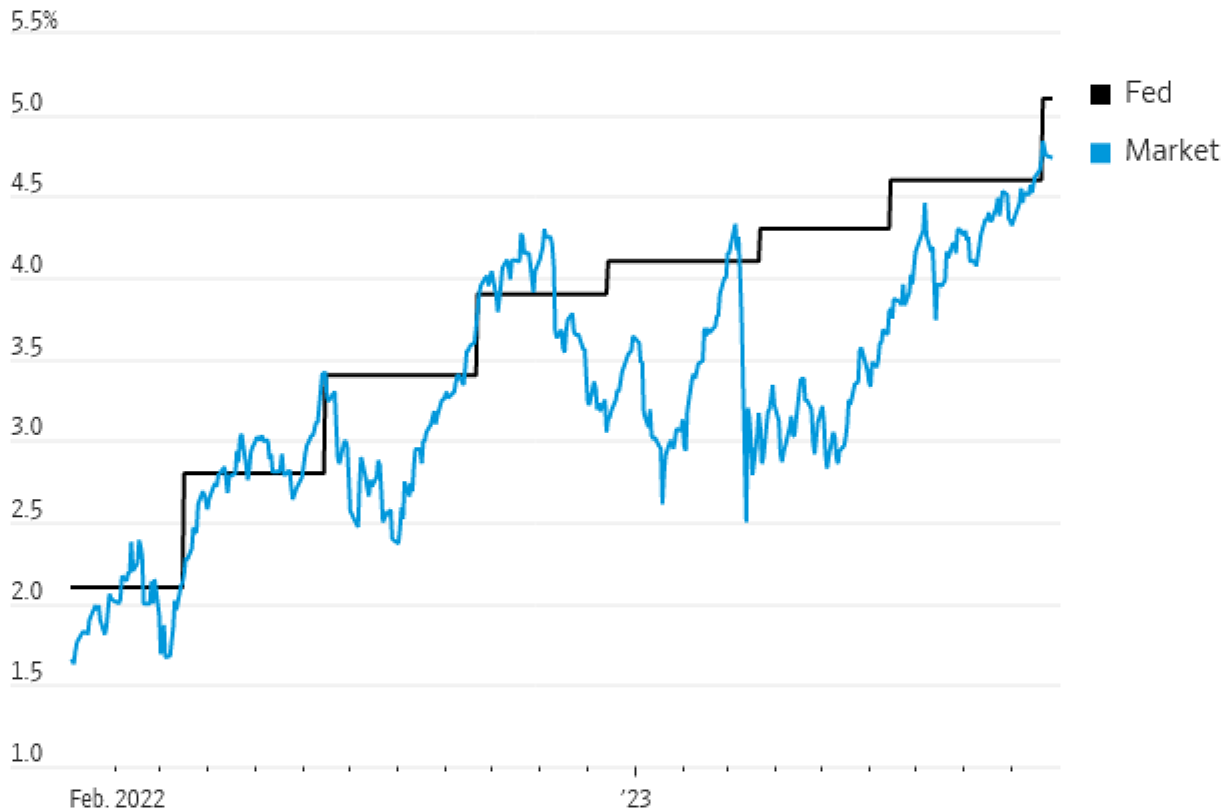
The Big Short is the name of a book and a movie about fund managers who saw the housing crisis coming and bet against housing related securities – earning a huge windfall in 2008. Now, Bill Ackman, a famous billionaire fund manager has a similar idea about betting against ("going short") long maturity U.S. Treasury Bonds. The thesis is that demographics, the renewable energy transition, de-globalization spawned by geopolitical tensions and covid, along with the political environment of high deficit spending, all point towards higher inflation and higher long term interest rates. (Higher interest rates imply lower bond prices).

While I agree with his thesis (about supply and demand for capital) for the long run, experience has taught me that you also need to get the timing right – especially when going short. In other words, even if he is right, if the thesis takes 5 years to impact securities prices, that will look the same as being wrong for the next year or 2 (or more). As I have explained in earlier newsletters, I think that ultimately politicians will stop the Federal Reserve from paying out billions of taxpayer dollars to keep short term interest rates high and there will be financial pressure to allow higher inflation. Although this scenario could get priced into the market at any time, I think it will likely take until at least 2025; after the next election because the current administration cannot afford to encourage higher

inflation given their track record (and after passing a law called the inflation reduction act).

Recent Developments Implications for Investing

The following graph comes from a Wall Street Journal article on September 25, 2023 after the Fed's most recent meeting:



The black line going up in a stair step fashion represents the Federal Reserve Bank's own projections for short term interest rates at the end of next year as they progressed from just over 2% in February 2022 to above 5% at their meeting this month. The erratic blue line represents the consensus of investors, as calculated from futures market prices. A couple of things stand out. First, the Fed has been consistently raising their forecast. Second, the market previously had discounted the Fed's projections and priced in lower rates – probably due to expectations of a coming recession. The reality, as demonstrated in the economic reports, is that the economy can withstand these higher rates without necessarily triggering a

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recession. Inflation is coming down, but without a recession, it will take quite some time to return to the Fed's target.

Given that interest rates are now above inflation (finally), and the Fed's new forecast for more rate rises and holding rates higher through 2024, the near-term environment for investing is looking more adverse to interest rate sensitive sectors. Previously, a recession-induced lower rate scenario looked much more likely than it does now. This has caused the market to push up long term interest rates significantly. This coincides with the convergence of the blue line in the graph toward the black line: market views moved up towards the Fed's projections.

Consequently, I plan to make allocation changes to better position for these circumstances. I still think inflation is a risk and that a long-term inflation scenario should be taken into account, but we can reduce exposure to strategies that are sensitive to the current high rate and declining inflation scenario. That means reducing allocations to the Real Estate portfolio and the Tax-Exempt Municipal bond fund portfolio. We can shift assets into Short Term income (which benefits from rising short term rates), into ETF Income which has lower interest rate risk than the Muni portfolio, and into International equities which have higher expected returns than the U.S. equity market in the current environment.

Real Estate Portfolio Strategy and Performance

The Real Estate portfolio was launched August 31st 2020 based on my expectations for a surge of inflation resulting from the pandemic's impact on production, and the government's large handouts designed to stimulate demand. In order to provide an investment protected against higher inflation, the portfolio was allocated 60% to residential REITs, 26% to self-storage REITs, and the remainder invested opportunistically in other real estate securities.

Currently this portfolio provides a dividend yield of 4.2% and that income gets favorable tax treatment as Qualified Business Income.

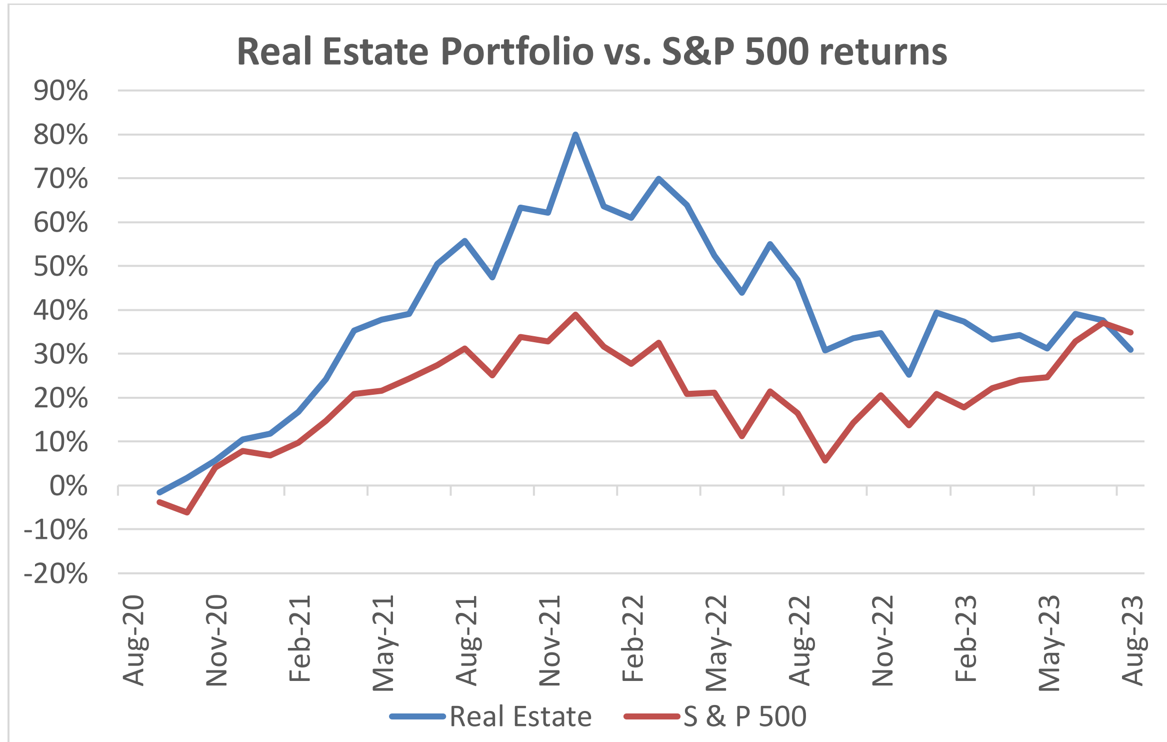
The results for the first year of this portfolio were spectacular. The total return, including dividends, capital gains, and price appreciation, was 55.7%. The portfolio peaked at the end of 2021 with a cumulative return of 80%! In 2022 it fell roughly in line with the overall market as the federal reserve pushed up inflation adjusted interest rates. I expect this portfolio to generally have a bit less downside risk than the S&P 500 index but the huge spike upward in December 2021 added a mean reversion effect on top of the 2022 decline in the overall market. The portfolio did well in early 2023 but in the last few months, market pricing has adjusted to reflect an expectation that the Federal Reserve will stay the course on higher real interest rates[1] and continue to push inflation towards its 2% target. Meanwhile the rapid run up in rents for apartments has slowed considerably. Thus, the fundamental drivers for this portfolio's returns have become unfavorable.

The graph on the next page shows monthly cumulative returns for the first three years in comparison to the S&P 500 stock index.

In 2023, the S&P 500 market index pushed higher based on a small number of stocks related to artificial intelligence technologies. Mania driven surges in certain stocks with good stories have become an ever more common feature of the

[1] Real interest rates means after subtracting out inflation.

market in recent years. In general, such gains are transitory and the market eventually corrects itself so that returns for long term investors follow actual business results rather than hopeful stories.



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 are shown in the table below.

Returns by Year

Year	Year Ended	Real Estate	S & P 500	Difference
1	8/31/2021	55.7%	31.2%	24.5%
2	8/31/2022	-5.7%	-11.2%	5.6%
3	8/31/2023	-10.8%	15.8%	-26.7%
	Compounded Total	30.9%	34.9%	-3.9%

The Real Estate portfolio performed horribly in its 3rd year, losing 10.8% while the S&P 500 gained 15.8%. This was bad enough to more than eliminate the very significant out-performance of the Real Estate portfolio in its first two years. As of August 31, 2023, its cumulative returns have fallen behind the S&P 500 (net of fees) for the first time.

Given the poor fundamentals for this inflation hedging portfolio, I have been making some adjustments to reduce exposure to multifamily residential companies that face the biggest challenges for future performance. Currently the portfolio contains 53% residential REITs (14% is single family homes), 28% self-storage, 12% in homebuilding, 5% in a diversified REIT, and the rest in cash. Rent growth

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for apartments has slowed dramatically and valuation multiples have come down with the decline in inflation. If wage increases do not follow inflation trends lower, however, rents will likely resume their upward march. Given the situation, it makes sense to maintain some allocation to the portfolio to provide upside in case inflation moves back above long-term interest rates.

As I alluded to at the beginning of this newsletter, recent events lead me to believe that the probability of a favorable environment for the real estate portfolio in the near term has declined enough to warrant a reduced allocation until we start to see signs of a lower real interest rates and higher inflation.

Long-Term Income Portfolio Strategy and 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. Normally, longer maturity bonds provide higher interest rates (yields) than shorter maturity bonds and are more sensitive to changes in interest rates. The current environment is unusual in that short term rates are higher than longer term 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 4.0 (it was 4.1 last year). If we hold a bond with duration of 5 when rates went up 2%, we would expect the bond's price to decline by 10% (multiplying the rate increase by the duration).

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 many issuers. This ensures that the extra premiums earned will not be lost due to a few companies defaulting. Our strategy is to accept market correlated credit risks to earn those extra returns.

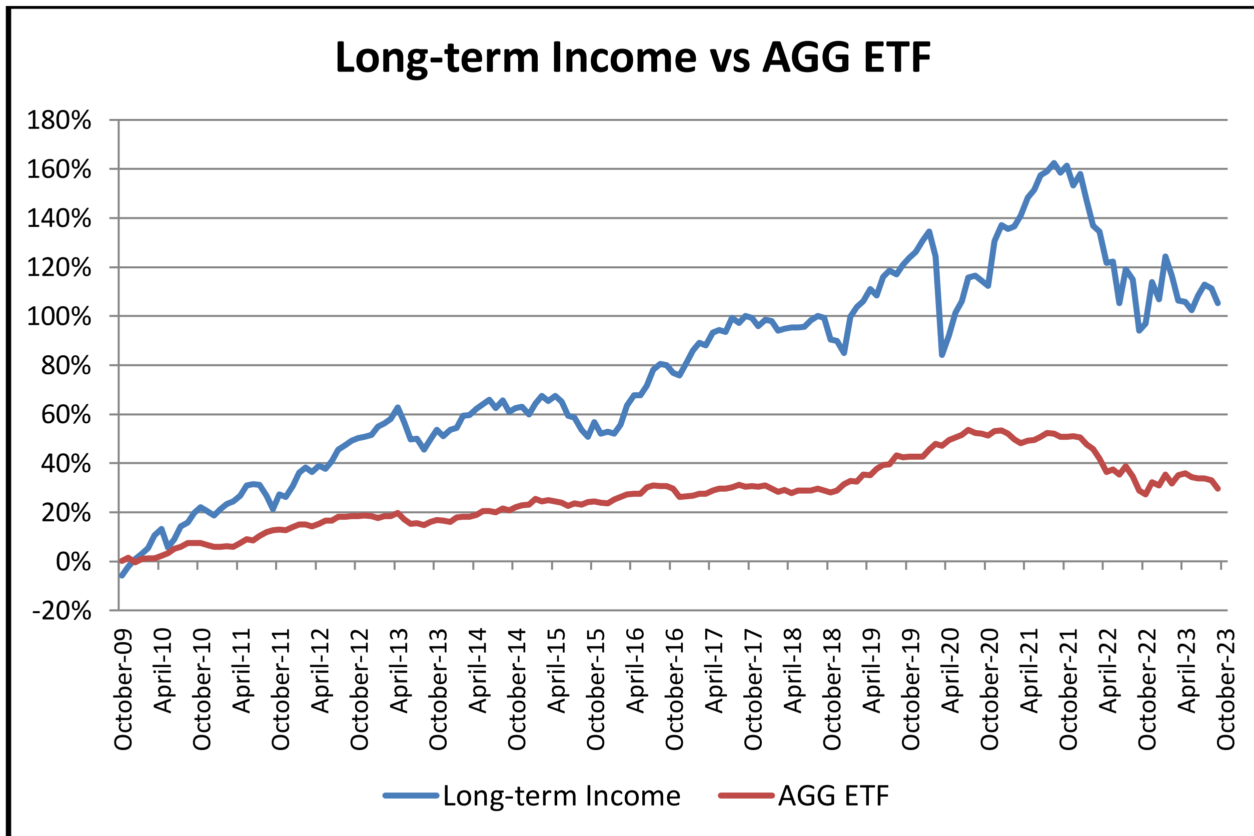
The extra return on high yield bonds over the interest rate paid by the U.S. treasury is called a credit spread – it is the compensation that investors demand for taking credit risks. These spreads change according to investors' risk preferences – i.e., how much they need to get paid for taking credit 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. Because leverage costs have increased significantly the advantages of closed end funds are a bit lower than under more normal market conditions. Current conditions are providing about .8% higher yield on our portfolio than if we held the underlying bonds directly (compared to a 2.6% advantage last year when the

advantage was extremely high). Prices of our holdings are at still at large discounts relative to the underlying bond values which partly offsets the loss of leverage benefits.

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.

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 graph above 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 AGG). Over the last year the portfolio return was **5.8%** compared to **0.5%** for its bond index benchmark (AGG). The total return over fourteen years was 105.3% - an annualized compound rate of return of 5.3%.

The Long-Term Income portfolio has experienced extremely high volatility in the last 2 years as interest rates have moved very fast and erratically thanks to the uncertainties around the path of inflation and Federal Reserve interest rate policies. The strategy has always had significant volatility in returns, but, prior to the surprisingly fast interest rate increasing campaign of 2022, the results have been good over periods longer than one year. The 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	Long Term Income	AGG Bond Index	Difference
1	19.8%	7.4%	12.4%
2	1.2%	5.0%	-3.8%
3	23.1%	5.0%	18.1%
4	0.2%	-2.0%	2.3%
5	7.6%	4.1%	3.5%
6	-6.4%	2.9%	-9.3%
7	19.4%	5.2%	14.2%
8	11.3%	-0.1%	11.4%
9	-0.5%	-1.3%	0.8%
10	10.9%	10.6%	0.3%
11	-2.9%	6.8%	-9.8%
12	20.5%	-1.0%	21.4%
13	-24.9%	-14.5%	-10.4%
14	5.8%	0.5%	5.2%
Compounded Total	105.3%	29.6%	75.6%

For the year ended 9/30/2023 the interest rate on 10-year treasury bonds increased from 3.83% to 4.52%. I estimate that this interest rate increase decreased the market value of the portfolio by around 2.8% compared to last year (4.1 average duration times the .69% interest rate increase). Remember our portfolio value moves in the opposite direction of interest rates.

The graph on the top of the next page shows credit spreads starting the month that Lehman Brothers collapsed. The median spread over this period is about 4.8% and spreads gyrate around this central tendency, driven by market sentiment. The current spread of 4.09% is 1.34% lower than last year. Although inflation tends to make it easier to repay debt, rapidly rising rates increases the probability of recession and financial distress. Spreads have declined as the market has re-assessed the likelihood of recession as much lower than thought last year. I estimate that the decrease in credit spreads contributed approximately 3.5% to offset the effects of rising rates over the last year. Generally, the level of risk-free interest rates (Treasury bond yields) and credit spreads push in opposite directions.

Most of the time, investment grade fixed income spreads move so little that the impact on our portfolio is minimal. In the current year, however, these spreads widened dramatically because of the bank failures earlier in the year. These investment grade spread increases significantly reduced values of investment grade preferred securities held in the Long-Term Income portfolio – thus reducing returns in the current year.

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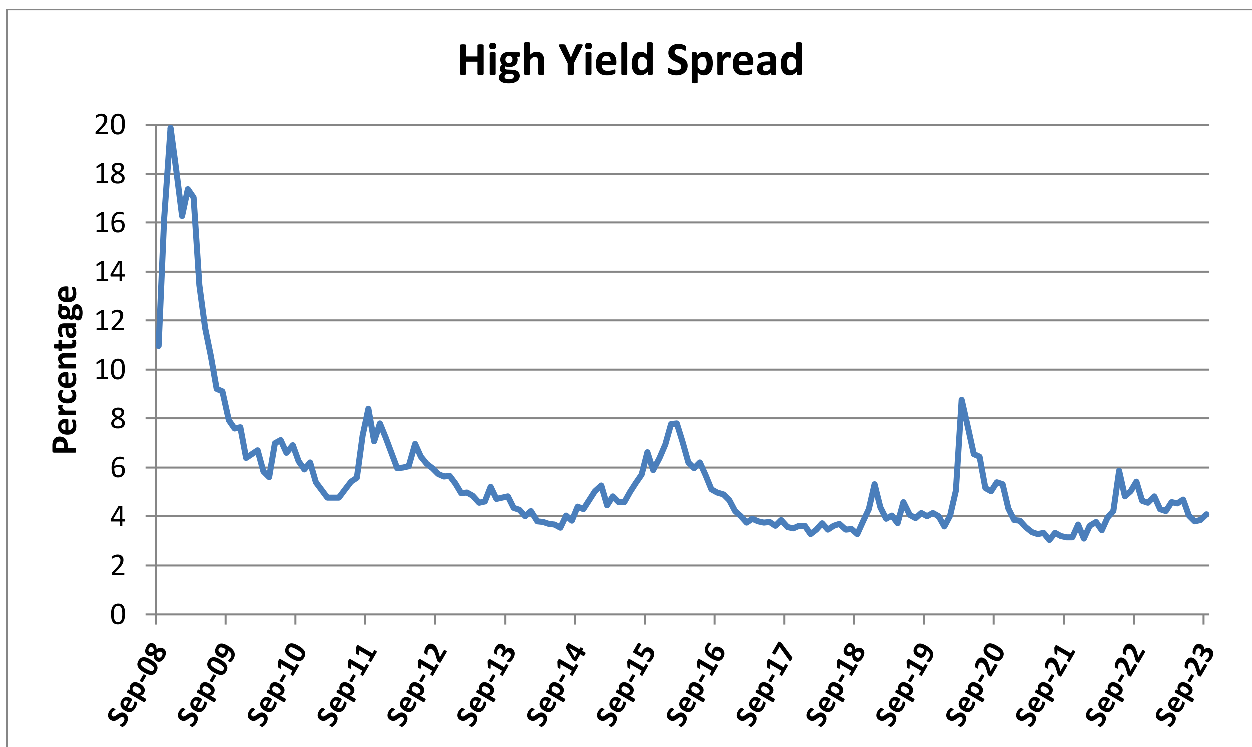
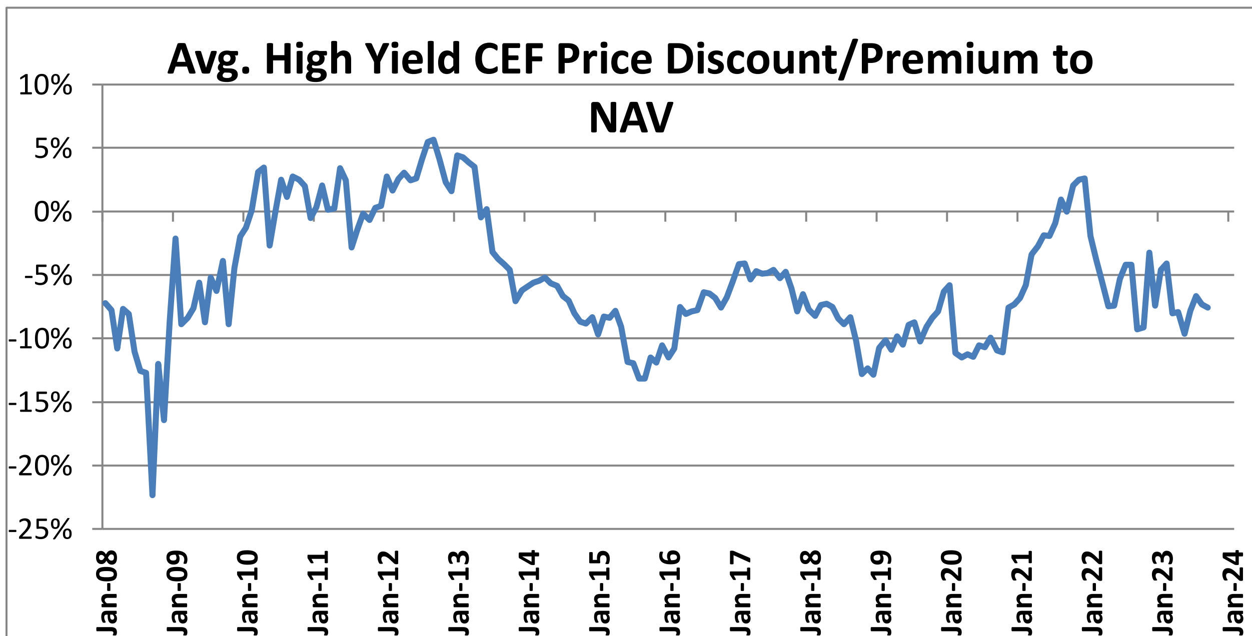


The portfolio's price returns (i.e., not counting interest payments) can also be impacted by changes in CEF prices relative to the underlying bonds. To determine the impact, we can look at monthly prices and net asset values (NAVs) for some representative CEF holdings. NAV represents the value of underlying 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 included in either the Long-Term Income portfolio or the Short-Term Income Portfolio. The chart above shows the average discount for these eight CEFs at the end of each month. We see that discounts last bottomed at 11.6% in March 2020 and then climbed back to reach a slight premium at 8/31/2021 before reversing back to just over 9% last year. Currently this measure is at 7.9% which is still a bit larger than normal. None of these funds are currently in the Long-Term Income portfolio.

As of 9/30/23, the yield on the Long-Term Income Portfolio is 8.1% (before fees). The weighted average CEF discount of the portfolio is at 12.1%. From these levels, the portfolio offers favorable expected returns relative to risks as compared to large cap U.S. equities. It may still under-perform equities over the next year but the odds are in its favor.

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