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Investment Newsletter – March 2024

Executive Summary

The Short Term Income portfolio bounced back, finally reaping the benefit of 2022's rapid rise in interest rates and credit spreads, as well as an opportunistic purchase of a particular fund. If the Fed follows through with expected rate cuts this year, it should raise income on long term closed-end funds but eventually decrease income on short term closed-end funds.

Short Term Income Portfolio Strategy and Performance

Berkeley Investment Advisors uses several strategy portfolios to manage client assets. The Short Term Income portfolio, which we focus on in this, its anniversary quarter, is a fixed income portfolio holding short to intermediate rate maturity loans and bonds. Typically shorter maturity bonds offer lower interest rates (yields) than longer maturity bonds (but not currently), and are less sensitive to changes in interest rates. This category includes securities with floating interest rates that can reset periodically depending on market conditions. For example the rate paid could be set based on Banks' "Prime Rate" or the 3-month term SOFR (Secured Overnight Financing Rate). These rates, in turn, change as the Federal Reserve Bank raises (or lowers) its "Fed Funds Rate".

The interest rate risk sensitivity of the portfolio is measured by its duration. Usually a short term bond fund strategy owns bonds with durations below 3. If we held a bond with duration of 3 when rates went up 1%, we would expect the bond's price to decline by 3%. The current duration of the portfolio is 1.4 but one year ago it was 1.4.

There is also credit risk in our portfolio –borrowers may default and not pay all that is due. High yield bonds have a higher probability of default than investment grade rated bonds, but lower rated bonds compensate by paying higher interest rates. It is this spread compensation that fluctuates depending on the market's current risk pricing attitude (mood). This pricing risk is related to equity market risk and fluctuations in the economy. We manage individual credit risk by diversifying across a large number of

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issuers. This ensures that the extra premiums earned will not get wiped out by a few companies defaulting. Our strategy is to accept credit risks to earn the extra returns associated with those risks.

The portfolio also earns incremental yield by holding closed-end funds (CEFs). For a detailed explanation of the advantages of closed-end funds see the March 2017 newsletter. To hold these securities we must endure more price volatility in down markets: retail investors want to sell more at lows. Currently we earn about .7% more yield on our portfolio than if we held the underlying bonds directly.

The portfolio is diversified across virtually all sectors of the fixed income market. The best comparison index is the "Barclays U.S. 1-5 year Government /Credit Float Adjusted Bond Index" as represented by the Vanguard Short-Term Bond exchange traded fund (ticker BSV). This is meant to represent the total short maturity U.S. bond market. It is not a perfect comparison to our strategy but there is nothing closer that has been in existence for the life of our portfolio.

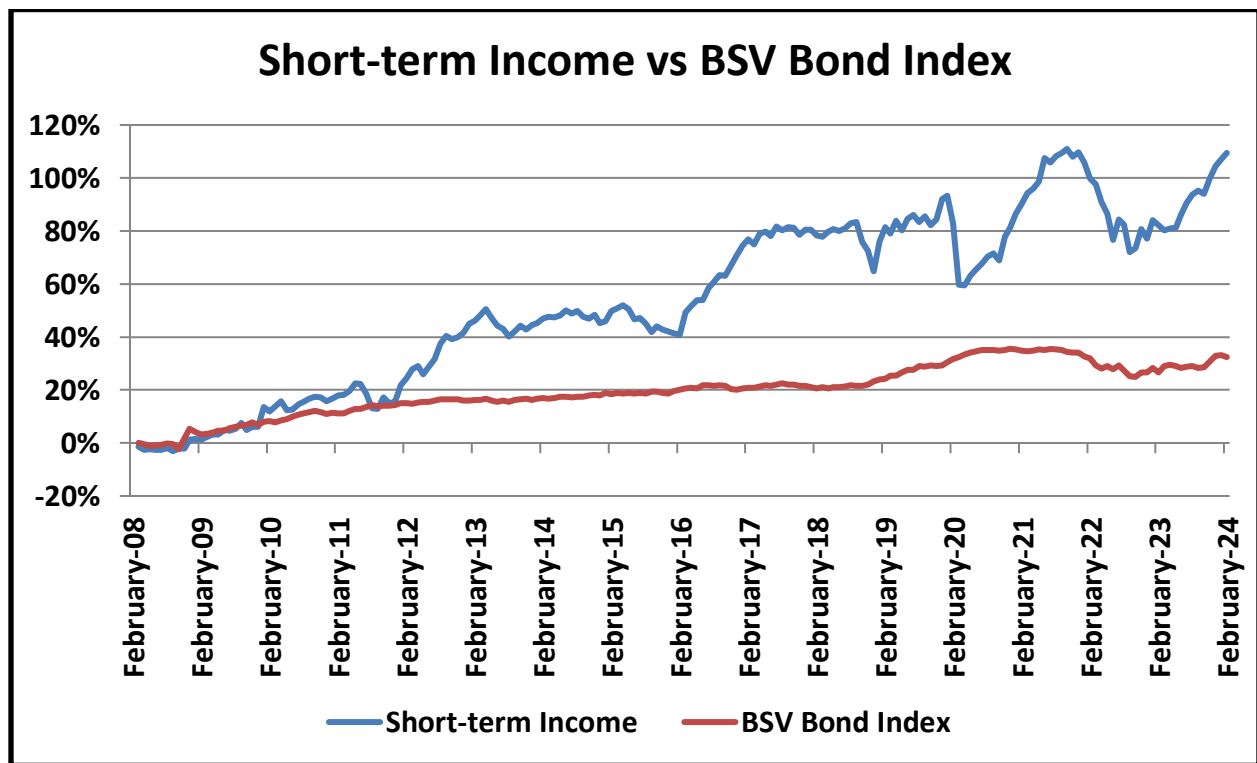
Some clients have had money invested in this portfolio since it was created in February 2008. The graph and the table on the next page show total returns including price and interest payments in comparison to the bond index mentioned above as implemented in the exchange traded fund (ticker BSV). Our 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 shows increasing volatility for the strategy's returns since the Pandemic started. This strategy has had losses in 2 out of 16 years (and underperformed its benchmark in 5 years), but generally there is lower risk of principal loss over a year's time than in other strategies - such as stocks or long term bonds.

The last year has been a bounce-back year. In 2022 the Federal Reserve raised rates so rapidly that the rate adjustments in our portfolio did not keep up. This, coupled with a more risk averse environment, led to a surprising (and counterintuitive) loss for the prior year. In contrast, the Fed slowed rate rises in 2023 and stopped raising rates after July. More stable rates combined with rising dividends led to good performance.

In addition, we took advantage of a rare opportunity in early 2023 which has paid off big over the last year. A fund (ticker FSCO) that had previously been a private fund, went public. Existing shareholder who had not previously had liquidity, rushed to sell. This drove the discount beyond 30% in early 2023. The steep discount combined with very high dividends resulted in a 30% return on this position over the last 12 months. This is an astounding result for a short rate maturity credit investment and it was by far our largest position. This demonstrates the inefficiency in the closed-end fund market that enables us to earn returns in excess of the benchmark.

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The table below breaks down the portfolio returns by year since inception.

Returns by Year					
Year	Year Ended	Short term Income	BSV Bond Index	Difference	
1	2/28/2009	1.4%	3.1%	-1.7%	
2	2/28/2010	10.3%	5.0%	5.4%	
3	2/28/2011	5.5%	2.7%	2.8%	
4	2/29/2012	5.5%	3.4%	2.1%	
5	2/28/2013	17.5%	1.1%	16.3%	
6	2/28/2014	0.5%	0.6%	-0.2%	
7	2/28/2015	2.0%	1.2%	0.8%	
8	2/29/2016	-6.0%	1.5%	-7.4%	
9	2/28/2017	25.5%	0.6%	24.9%	
10	2/28/2018	0.9%	-0.1%	1.0%	
11	2/28/2019	1.7%	2.9%	-1.1%	
12	2/29/2020	0.9%	6.2%	-5.3%	
13	2/28/2021	3.9%	2.3%	1.6%	
14	2/28/2022	5.1%	-2.2%	7.3%	
15	2/28/2023	-8.9%	-4.0%	-4.9%	
16	2/28/2024	15.1%	4.5%	10.6%	
Compounded Total		109.5%	32.4%	77.1%	

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Over the last year, the strategy return was 15.1%, while the Vanguard Bond Index Fund earned 4.5%. The cumulative return for the strategy from 2/29/2008 to 2/28/2024 is 109.5%. Thus the annualized compounded rate of return since inception (16 years ago) has been 4.73%.

Over the past year credit spreads have declined by .93% which should have increased the portfolio value by about 3.5%. In addition closed-end fund discounts declined about 3%, also contributing to the mark to market gains of this portfolio. Despite this, the current average closed end fund discount in the portfolio is still 7.5%.

The portfolio's current dividend yield of 8.0% is still quite high. Last year I expected to shift away from this portfolio as the risk of higher rates abated. However, given the very uncertain outlook for rates and the high yield currently being earned, I will be patient in timing any shift into the Long Term Income strategy.

The Impact of Coming Federal Reserve Rate Cuts

Federal Reserve officials say they expect to start reducing interest rates this year because they expect inflation to continue moving toward their target. As this newsletter has pointed out over the last 3 years, they are frequently wrong in predicting what they will do in the future. So we should never assume their projections are a sure thing. However, if their expected scenario comes true, it's worth considering the implications for investing.

When the Federal Reserve (the Fed) talks about changing interest rates, they are only talking about the short term rates they can control. They control the overnight lending rate between banks by setting the rate the Fed pays on banking reserves held at the Fed. This is equivalent to a market benchmark called the SOFR which stands for Secured Overnight Financing Rate. There are also "SOFR" rates that are for longer terms (i.e. not overnight) up to 12 months. The Fed can also set these rates via its market lending facility. On the other hand, it does not directly control rates for maturities beyond 1 year. It does have some impact on longer term rates through its transactions in the bond market. Currently the Fed is only replacing some bonds as they mature so that total long bond holdings are declining as they reverse the "quantitative easing" policy of previous years.

While short term rates are very important for the economy (because bank loans are usually priced using them), the 10 year Treasury bond yield is a much more important price of money for investors and larger corporations. The 10 year rate is a benchmark for pricing longer term bonds and mortgages. When rational investors estimate the value of stocks, they discount expected cash flows over the long run using longer term interest rates. Therefore, rises in the long term rate should reduce stock prices all else being equal.

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Changes in short term rates influence longer term rates through expectations. That is, if investors expect short term rates to be higher over the next 10 years because they are higher now, then they will change their requirements for 10 year bond yields and market prices will adjust to raise rates. Thus the Fed can influence longer term rates with their communications about what they *think* they will do in the future – but only to the extent that the market agrees about the path of short term rates over the long term.

Since 2022 the bond market has had what is called an inverted yield curve. This is a situation where short term rates are higher than long term rates and so a graph of rates by maturity will slope downward. In normal times such a graph of the yield curve slopes upward. Hence the term “inverted” means opposite of the normal situation. Usually an inverted yield curve happens just prior to a recession. As the Fed raises rates, the market expects that in the future the economy will slow and rates will come down so it will keep bidding lower yields (higher prices) for the longer maturity bonds. This is a bad situation for banks because they make a good portion of profits by paying short term maturity rates to depositors and lending out for longer terms at higher rates. Inversions lead to bank distress as we saw with the 3 bank failures last year.

Now let’s consider how short and long term rates effect closed-end funds (CEFs) holding bonds and loans. These funds generally borrow against their assets at floating short term interest rates just as banks do. For the funds that held long term bonds, the rises in longer term rates in 2022 caused mark to market losses. (The banks also had such losses but generally do not report them under bank accounting rules). While these value declines were most noticeable, short term rates also had an adverse impact as they raised the costs of fund borrowings. This, in turn reduced the net interest income available to pay dividends to fund owners.

In order to illustrate, we can look the impact on interest costs and net investment income at Nuveen Taxable Municipal Income fund, ticker NBB. Comparing this fund’s financial statements for the 6 months ended 9/30/21 to the 6 months ended 9/30/23, we find that the interest cost as a percentage on borrowings rose from .68% to 5.30% in line with what the Fed did in 2022. Thus the borrowing costs for this fund rose 510% in dollars from 2021 to 2023. This reduced the fund’s investment income available to pay to investors. There were also adverse effects from the associated rise in longer term rates because the assets of the fund declined in value and therefore the fund sold assets so as to repay some borrowings. But in looking forward, since we don’t know what will happen with longer term rates, we’ll focus on the impact of short term rates changes. Based on the fund’s reported assets and liabilities at 12/31/23, I estimate that for each Fed interest rate cut of .25%, the net interest income of NBB will rise by

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3.84% compared to the situation if the Fed does not lower rates. At the Fed's March 2024 meeting they expected to cut rates by .75% in 2024. If they do so, this fund's income should rise 11.5%.

Although the Fed (and the market) expect the rise in short term interest rates from 2022 to 2023 to be a temporary situation, reduced dividends probably led some CEF investors to sell their funds at a bigger discount as a result. This is why the Muni Fund market has traded at the largest discounts on record: retail investors reacted to reduced dividends in 2022 and 2023.

In conclusion, it is likely that the Fed will start lowering rates in 2024 and this will lower interest expenses for closed-end funds. We should see one or more dividend increases for the example fund above (NBB) as well as other CEFs held in the Long Term Income portfolio. On the other hand, we could see dividend decreases in the Short Term Income portfolio because the decline in borrowing costs will be offset by declines in the interest rates received on floating rate investments. Just as on the way up, there will be a lag in this process; so it is more likely to take until 2025 for there to be any impact on these funds' dividends.

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