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## Investment Newsletter – June 2012

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Berkeley Investment Advisors marked its 10<sup>th</sup> anniversary in May! I don't feel any older, just wiser. I've learned a few lessons about investing along the way; more importantly, I've learned that clients may think differently than I do and therefore I need to understand them to help them. Being an effective financial advisor, is not just about numbers and analysis, it's also about people, their emotions and their goals.

In this anniversary newsletter, we'll take a look back to compare the real estate opportunities today with what we saw 10 years ago. I will also explain stock market hedging techniques and recent changes in our strategy. Finally, we'll cover the current economic and market environment.

### **The California Apartment Market - Past and Present**

Ten years ago, the best deals in the California real estate market were in the central valley – Sacramento, Stockton, Modesto, etc. Despite being based, in San Francisco, after analyzing the potential returns in the coastal cities versus inland, I joined the Sacramento multiple listing service because the best deals were there. Apartment prices in Sacramento rose 20% in 2002 and continued upward over the next several years. By 2005 we stopped advising clients to buy real estate in California. Over the last few years, the banks have taken back quite a few properties and sold them back into the market, driving prices back down to levels that provide good returns – especially Sacramento.

Because rents declined with the oversupply of housing, property values are now significantly below replacement costs. Now it doesn't make sense for anyone to build new apartments until rents and values go up enough to make it profitable to build again. Vacancies are dropping; soon we will start to see rents rising more quickly. Values will follow. Some areas will see a 50% increase before there is a supply response. In other words, we've come full cycle. At current loan rates, it's a very good time to be a buyer. Earlier in the cycle there were even some good deals in the Bay Area. These are gone. Once again, buyers need to look further inland for acceptable returns.

Although there are good deals, it is still not easy to identify them. When we look at advertised income and expenses for apartments, 95% of the time the net income turns out to be significantly overstated. If you are trying to find deals on your own, don't take advertised numbers at face value. Let's look at an example to

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illustrate the problem. Below is a table showing net operating income for an apartment building in Modesto from an April advertisement:

Income	Current	Pro Forma
Gross Potential Rent	\$97,200	\$99,720
Other Income	\$3,600	\$3,600
Gross Potential Income	\$100,800	\$103,320
Less: Vacancy/Deferrals (GPR)	5.0% / \$4,860	5.0% / \$4,986
Effective Gross Income	\$95,940	\$98,334
Less: Expenses	\$38,761	\$38,761
Net Operating Income	\$57,179	\$59,573
Net Cash Flow Before Debt Service	\$57,179	\$59,573
Debt Service	\$32,263	\$32,263
Debt Coverage Ratio	1.77	1.85
Net Cash Flow After Debt Service	10.0% / \$24,916	11.0% / \$27,310
Principal Reduction	\$0,380	\$0,380
Total Return	14.6% / \$34,266	15.6% / \$36,660

Here are my calculations after obtaining documentation of actual performance:

Annual Scheduled Gross Income		\$	100,800
Less Rent Concessions		\$	-
Less Vacancy & Credit Losses	16.0%		15,552
Effective Gross Income (EGI)			85,248
Less Expenses @	50%	of EGI	42,910
Net Operating Income after reserves (NOI)			42,338
Less Loan Payments			38,851
Cash Flow (Pre-Tax)	1.3%		3,487
Plus Principal Reduction			6,631
---->> Plus Expected Appreciation	1.1%		8,536
<b>Total Return on Investment Before Taxes</b>	<b>6.9%</b>	<b>\$</b>	<b>18,654</b>

In this particular case the operating expenses were fairly accurate – except they didn't account for reserves for major capital replacements (roof, parking lot, etc.). Notice, however, that I found out that vacancy losses were 3 times the amount advertised. Because lower income will require a lower loan amount and higher cash investment, the reality is a cut in returns by more than half – too low to make sense. Almost every deal I've looked at in the last 6 months has had expenses understated and collected rents overstated. Buyer beware! (For a primer on estimating income, expenses, and returns for apartments, see the January 2004 newsletter).

Now, let's look at an example with good returns to give you an idea of what is really available. Here is the calculation of income and returns for a fully renovated 11 unit apartment building recently offered for sale on 50<sup>th</sup> Avenue in Sacramento:

Annual Scheduled Gross Income		\$	98,736
Less Rent Concessions		\$	-
Less Vacancy & Credit Losses	6.0%		5,924
Effective Gross Income (EGI)			92,812
Less Expenses @	48%	of EGI	44,990
Net Operating Income after reserves (NOI)			47,822
Less Loan Payments			39,640
Cash Flow (Pre-Tax)	3.9%		8,182
Plus Principal Reduction			10,961
---->> Plus Expected Appreciation	1.4%		10,591
<b>Total Return on Investment Before Taxes</b>	<b>14.2%</b>	<b>\$</b>	<b>29,733</b>

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The asking price on this property was about \$79 per square foot - \$67,000 per unit (all two bedrooms). This price is just 7.4 times gross rents. The gross yield on the property (before subtracting financing costs), also known as the capitalization rate, is 6.5%. As you can see in the exhibit above, this generates a 14% return on equity invested – even with a very conservative estimate of rent driven appreciation. The reality is likely to be accelerating rent increases over the next few years with values and returns following accordingly.

There are even better deals with more upside if you buy properties needing renovation. We recently closed a deal at a price below \$59 per square foot; it needs about \$10 per square foot in repairs. When thinking about these numbers, keep in mind that it would cost at least \$130 per square foot to build new buildings – not including land costs.

In contrast, the best deal recently available in the large metropolitan areas along the coast was an 8 unit complex near San Diego that would have cost \$199 per square foot including necessary repairs. This would be 9.3 time gross rents. Unfortunately, the property was master metered – meaning the landlord pays all utilities. Taking into account these costs the capitalization rate was just 5.3% so the return on equity would likely be around 7% - half that available in Sacramento. Returns on offer in the Bay Area and Los Angeles are generally lower than this (though not as low as prior to 2009 when prices were high enough to imply negative returns).

Marginal deals are possible in some outlying areas such as Sonoma and Solano counties. In April we looked at a 10 unit deal in Cloverdale. Taking into account repairs and reserves for a septic system upgrade, the estimated return on equity was just below 8%. A very well priced property came up in Fairfield but it turned into a bidding war and the seller asked for a cash purchase – essentially negating the benefits of the low asking price.

The bottom line: its déjà vu all over again for California Apartments. Just as in 2002, good deals are available but you'll need to do your homework to buy right - in advance of a likely upswing in rents and prices over the next few years.

### **Hedging Equity Market Risk**

Starting this month Berkeley Investment Advisors is using an active shorting strategy to reduce hedging costs and improve performance for clients in our hedged equity strategy. We will explain the new strategy, but first we'll give an overview of the what, when, why, and how of hedging.

When it comes to investments, the term hedging means that you are reducing the risks of your investments by entering into transactions where you expect gains in situations where your other investments will lose money. In a sense, it's like property insurance which pays off when you have a loss on your property. So, if I own a portfolio of stocks and I want to hedge their risk, I need to find a security that pays off when stocks go down - so that losses on my stocks will be offset, or at least partially offset.

The obvious reason why you would hedge an investment is to reduce risk. We may want to do this when we recognize that downside risks are large relative to expected returns on the market as a whole. Even if our particular portfolio seems to offer good returns relative to risk, it may experience a significant decline if the overall market drops enough. Such declines tend to cause investors to sell after losing a lot of

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money. It's better to avoid this possibility even if it means giving up some upside. A good strategy for hedging is to look at the statistical probabilities for losses on the market as a whole and put on your hedge when the average outcome is negative. This is analogous to strategy games where probabilities come into play – like adjusting your bets according to the card count at a Blackjack table or in response to the probability of losing a hand of poker. If we can play the odds this way, over the long run we'll do better than ignoring changes in risks and returns.

We can also reduce risk by simply selling our stocks. There are several reasons why it might be better to hedge instead. First, you may wish to avoid the tax effects of selling your positions. Second, because you can choose to hedge general market risk rather than your specific stocks, you can still earn extra returns if your stocks do better than the overall market. Third, you may choose to incrementally hedge only part of the market risk depending on conditions. Think of it as a dial whereby you control your market exposure in response to how favorable or unfavorable conditions become. Also, it is much easier to adjust a hedge position to change your risk and return than to buy and sell a whole portfolio of stocks.

When we decide it's time to reduce our general equity market risk by hedging, we need to measure our portfolio's sensitivity to this risk. This measure of sensitivity is called the Beta of the portfolio. For example, if I have a \$100,000 portfolio and its Beta is 1.5, that means for every 1% move in the overall market, this portfolio will move by 1.5% - meaning \$1,500. To give this practical meaning, we must define the reference index of market returns. This may depend on what you are using for your hedge, but most people use the S&P 500 index as the measure of the market. Therefore, in the example above my hedge would need to give me a gain of \$1,500 whenever the S&P 500 declined by 1%.

There are various possibilities for creating such a hedge. One way is to use "Put" options on an exchange traded portfolio of S&P 500 stocks. A Put option is a contract that gives you the right (but not the obligation) to sell a security at a fixed price (called the strike price) within a certain period of time. Let us consider Put options on the SPDR S&P 500 fund (ticker SPY). SPY ended at a price of \$136.10 on June 29, 2012. At that time we could buy a Put with a strike of \$136 for \$1.77 per share. Suppose we bought Puts on 1,000 such shares, worth \$136,100. Now suppose SPY drops 10% to \$122.49 at the expiration of our Put. At that point we have the right to sell 1000 shares for \$136,000 when they are only worth \$122,490. Therefore our Put contract is worth \$13,510. Subtracting our purchase price, we would make \$11,740 on the hedge. On the other hand we could expect our stocks to lose 15% (1.5 Beta \* 10%) = \$15,000. So this would be only a partial hedge. We could buy more Puts to match exactly our market exposure if we desire. We can also offset the costs of the Puts through more elaborate hedging positions where we simultaneously sell other options to cover our costs. This is a rather complex area which we won't cover further, but the point is we can use options to offset market risks.

Another way we can make money when stocks decline is by going "short". This means we borrow a security that do not own, such as SPY above, and sell it for cash. When we do this we have the sales proceeds but also a liability to buy back SPY at a later time and return it to its owner. This operates very similar to the Put option. If we sell 1,000 shares for \$136,100 and SPY drops 10%, we can buy it back for \$122,490 to make a gain of \$13,610. Again, the idea is that this would offset losses

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in our portfolio; we have to choose a size to adjust our risk according to our views. Note that if we use the short position instead of the Put, we will lose money on the hedge when the market goes up. This should be offset by gains on our portfolio. So the net effect is to reduce both up and down moves in our overall portfolio.

Besides the direct shorting strategy described above, there are exchange traded funds (ETFs) that do the short positions for you. In other words you buy these funds like a regular stock but they go the opposite direction of whatever market index they are shorting. For example "Proshares Short S&P 500" (ticker SH) is a portfolio of short positions in the S&P 500 index stocks. This product is designed such that its percentage move over any one day will be approximately the negative of the percentage move in the S&P 500. (I.e. its Beta is -1). So we can just buy an appropriate amount of this to hedge our portfolio. There are also "Ultrashort" ETFs which offer returns of approximately -2 times the return of the underlying index.

Short index ETFs are nice products – especially for retirement accounts that otherwise may not be able to use options or go short. There is, however, a cost. Because of their design these funds must rebalance their short positions daily. When the market goes down they need to sell more stock. When the market goes up, they need to buy back some stock. In other words, they are forced to continually buy high and sell low. The adjustments are relatively small but over time this causes the funds to "leak" money. It turns out that the Ultrashort funds leak a lot more than the regular short funds so they should be avoided where possible. Because of the leakage, if you hold these long term, they will not perform in line with the underlying index. In 2011 when the market was flat, SH lost 7.8% and the UltraShort S&P 500 (SDS) lost 18.8%.

Just as we can pick a portfolio of stocks that will have higher returns than the market, it is possible to actively choose a set of stocks that we expect to perform worse than the market. If we are good at this, it would be a superior hedging strategy because in a down market such stocks will go down more (so we get bigger gains) and in an up market these stocks would underperform the market (so we have smaller hedging losses). Of course, shorting requires a somewhat different approach to finding stocks to buy and we would need the ability to borrow and short the shares – which is not always easy or even possible. In 2011 such a strategy was launched as an exchange traded fund. This means that there is a dedicated "short" manager picking the stocks most likely to underperform and the returns for this strategy are available to everyone (even retirement accounts) via an ETF called Active Bear (ticker HDGE).

Like Berkeley Investment Advisors, the managers of this fund concentrate on a limited number of positions that they have high conviction in shorting (which they can follow closely). In such a situation it's important to be able to look at historical performance to determine the likely performance of the fund as a hedge. We've now reached a point where there is sufficient data to analyze the fund's performance. Therefore I downloaded the funds return data June 8<sup>th</sup> to see how it performed relative to the S&P 500 index. Over the life of the fund, its Beta was -1.09, meaning that on average if the S&P index moved 1%, the fund moved in the opposite direction by 1.09%. After adjusting for the expected returns over the period given this Beta and the performance of the S&P 500, I found that the fund had excess return of 7.1%. This means that, over time, unlike the "money leakage" of the short ETFs discussed

previously, this fund pulls in extra money. If this continues to perform as it has, we can use it for hedging without the costs associated with the other methods. We switched our hedging strategy to using HDGE immediately after analyzing the fund's strategy and results. This should provide us with another source of excess risk adjusted returns for our clients.

### **The Current Economic and Market Environment**

Economic news continues to be negative. Europe is in a deepening recession and leading indicators show that the U.S. will follow. For large U.S. companies, the recession in Europe will take a bigger toll on profits than it will on the U.S. economy as a whole. We should experience a mild downturn. The Federal Reserve has indicated that it will launch yet another quantitative easing (market intervention) to try to encourage risky investments. The only purpose will be to kick the economic adjustment process further down the road. This may cheer market speculators for awhile, but it will do little for the real economy. Statistically speaking the odds are we'll see negative stock market performance in the next few months.

At last week's European summit, the Germans surprised everyone by agreeing that someday, after they've put appropriate rules in place, the Southern Europeans can borrow some money from German taxpayers. It still seems unlikely that they will lend it out without a good chance of getting it back. Meaning, not much has really changed. It will take years for the Southern Europeans to make the adjustments needed to live within their means. Despite last week's relief rally in the markets, this is not over by a long shot. I predict that we will be writing much more about this in the September newsletter.

While I would love to join the party by going all-in on the equity market, it is simply not justified by the current combination of high risks and low offered returns. Although it is very frustrating to see how events are playing out, the key, as always, is disciplined patience. Our chance will come - most likely sooner rather than later.

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