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Investment Newsletter – March 2011

This month marks our sixth anniversary of managing client money in the stock market. We will present our results, but first we'll give our assessment of the effects of the Federal Reserve's Quantitative Easing (QE) program on the economy and the markets. We'll also dissect the differences between economic risk and valuation risk in the equity market and the implications for hedging and risk management for investors. We'll end with a discussion of current investment opportunities.

Primer on the Federal Reserve and Monetary Policy Implementation

The U.S. Federal Reserve Bank (the "Fed") controls short-term interest rates and the money supply by buying and selling debt securities in the market, and by setting the interest rate paid on reserves (money) held on deposit at the Fed. When the Fed wants to lower interest rates to encourage expansion of economic activity, it must increase the supply of money available to the banking system by buying securities for cash. In reality, paper money need not be created because the banks keep this money on deposit at the Fed. These deposits are called reserves and banks are required to hold a certain ratio of reserves (i.e. money) relative to the loans they make to the public. When a bank has money on deposit at the Fed in excess of its required reserves, it has an economic incentive to make short-term low-risk loans or investments that pay a higher rate than the Fed (which currently pays .25%). The result is that low interest rates are transmitted throughout the economy.

Note that the mechanism described in the above paragraph pertains to short-term low-risk rates only. Longer term interest rates, like mortgages, involve risks such as changes in short-term rates and default risks. In normal times, these longer term rates are only indirectly affected by the Fed through the market's expectations of what the Fed will do in the future.

What is Quantitative Easing and How Does it Affect the Economy?

Quantitative easing (QE) happens when the Fed continues to buy securities in the market so as to increase the supply of money (reserves) held by the banks beyond the amount required - after short-term interest rates have already hit bottom (0 to .25%). The terminology comes from the fact that they are increasing the *quantity of money* beyond the point where that

can lower short-term interest rates. In normal times the Fed buys short-term U.S. government Treasury Bills when it wants to increase the money supply. Under the quantitative easing policy the Fed buys longer maturity securities, including 30-year mortgages.

When the Fed buys longer term bonds and mortgages, that buying pressure will tend to push up prices beyond what they otherwise would be. For any security (e.g. bonds, mortgages, or stocks) a higher current price for the same set of future cash flows means that the yield or return on the security will be lower going forward. Hence the Fed is trying to lower long-term interest rates – including mortgages.

In the financial markets there are a wide variety of potential investments - all with differing risk characteristics and expected cash flows. The prices, and therefore expected returns, are constantly changing. Investment managers constantly survey the opportunities and buy and sell securities so that the *expected return per unit of risk* in their portfolio is optimal for them. As the Fed forces more money into the financial system, somebody must hold it; this causes the markets to adjust the prices and returns on all assets. Asset prices go up and future returns go down such that those holding cash are OK with foregoing the returns per unit of risk that the market is offering on all other ways to store wealth – i.e. securities, real estate, commodities, and bank deposits. If interest rates do not adjust lower to reduce the incentive to get rid of cash, money will lose value versus all other goods and services – i.e. we get inflation. This depreciation of the value of money always starts with commodities since they can be stored and serve as a way to preserve future purchasing power of savings. We already see this effect in the prices of gold, oil, and food.

The quantitative easing policies of the Fed were carried out in two rounds. In March 2009 the Fed announced the first round of quantitative easing (QE1), in which it would buy \$300 billion of long-term treasury bonds, \$100 billion of Fannie Mae and Freddie Mac bonds, and \$750 billion of mortgages over the rest of the year. This action caused market participant to re-price risks of the stock market by bidding up prices. Note that quantitative easing does not change the real amount of future corporate earnings; it merely changes the current price of those future earnings. Rising stock prices and the increased government spending in the stimulus package contributed to a more positive outlook among consumer and businesses. The perception that the government would not allow things to get worse improved people's outlook and thereby caused them slow the speed of paying off debt and consume more, thereby increasing economic activity– taking us out of the recession.

Neither the fiscal stimulus nor quantitative easing work towards solving the economy's underlying problems that led to the recession in the first place. A large part of the nation's consumption, and therefore economic activity, was driven by borrowing money at low interest rates against inflated house values.

This consumer borrowing binge has stopped and been replaced by a government borrowing binge to support (less useful) economic activity. As we wrote in the June 2010 newsletter the current level of government borrowing and spending is unsustainable in the long run.

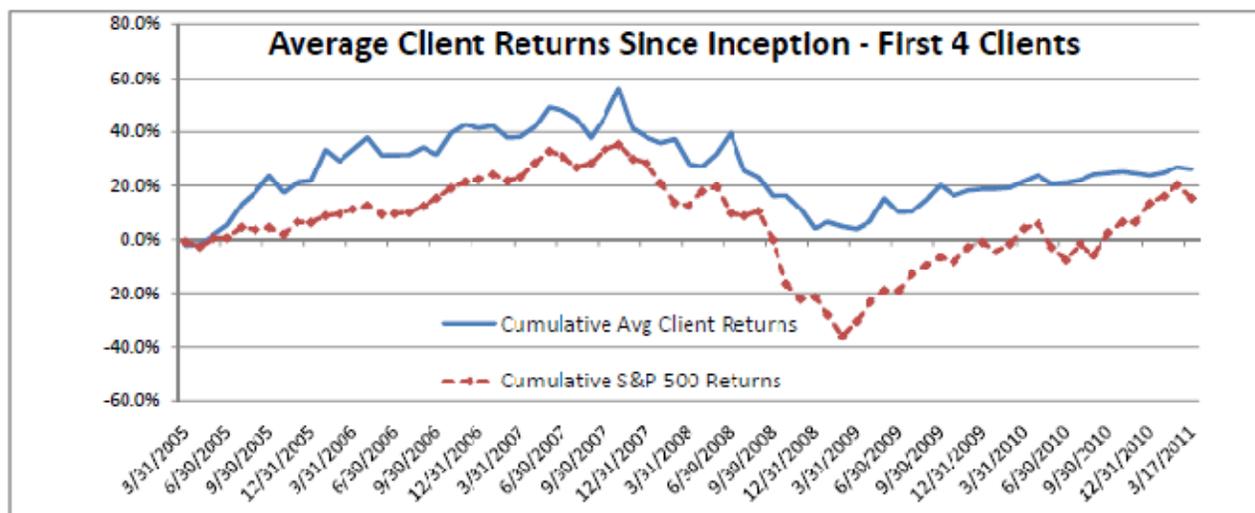
The Fed seems to believe that by pushing up financial asset prices with quantitative easing it can induce people to spend enough of their new “wealth” to get back to past levels of consumption. Historical data shows that this does not happen. In the aggregate consumers are not fooled into spending any significant portion of temporary increases in stock portfolio values. In fact, many cannot because most of these assets are held in retirement accounts. Thus the only real effect on the economy is by improving the mood of the country. Judging by the most recent consumer confidence survey, even this effect is now waning.

Despite this somewhat pessimistic view of QE, economic statistics have turned much more positive since last June and I am not predicting an outright recession. Still, growth is likely to slow over the rest of the year as government spending is reined in and QE2 winds down in June.

Performance Review for 6 Years Ended 3/17/11 (Since Inception)

At Berkeley Investment Advisors, we implement our investment strategies in a number of different risk portfolios – into which we allocate client money according to their risk tolerance. Our primary equity portfolios are called Long-term Value (which hit its 6 year anniversary in March 2011) and the Special Situations portfolio which came just a bit later. Since January 2008 we’ve used a “Hedge” portfolio to reduce the risks of the first two strategies under adverse market conditions. We’ve also had a substantial allocation of client monies to both long-term and short-term bonds.

The chart below plots the cumulative returns for the overall blended portfolio recommendation (for the average of the first 4 clients) over the 6 years ended March 17, 2011 as compared to the S&P 500 index.



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These 1st four clients earned an average cumulative return of 26.3% compared to 15.4% for the S&P 500 over the same time. The following table breaks down returns by calendar year.

First 4 Clients Average Returns Over 1st 6 Years

Returns Comparison	From Mar 17						to Mar 17th		Cumulative Since Inception
	Year	2005	2006	2007	2008	2009	2010	2011	
Average of Client Returns		21.8%	16.1%	-2.4%	-24.6%	14.2%	4.2%	2.0%	26.3%
S&P 500 Return		6.2%	15.2%	5.1%	-39.0%	26.4%	14.6%	1.7%	15.4%
Difference		15.6%	0.9%	-7.5%	14.4%	-12.2%	-10.4%	0.3%	10.9%

As shown above and on the previous page, client portfolios had outstanding performance from inception in March 2005 up to October 31, 2007 when cumulative returns peaked at 56%. In January 2008 we put on hedges against further expected market declines. Consequently we did not lose money for the first 6 months of 2008. After that, the rapid drop in oil prices and very high volatility rendered our hedging instruments less effective than expected. Still, we were able to break even in October 2008 when the market was crashing and our portfolio was also close to break even in the early 2009 market drop.

After the market bottomed in March 2009, we remained defensive throughout the subsequent rally because we were more concerned with protecting against principal losses than speculating on a favorable market response to QE and a "less bad" economy. Although we have performed well over the full 6 years, we have significantly under-performed the market in the last 2 years as it has rebounded from the lows. We have remained defensive – first because of economic risks and later because the market became over-valued, over-bullish, and therefore over-risky.

In particular the last four months of 2010 was particularly frustrating. As of the end of August 2010 our cumulative return was more than 30% over that of the S&P 500. Over the next 4 months we essentially broke even while the S&P 500 gained 21%. This deserves some comment.

On August 27th the Chairman of the Fed gave a speech in which he laid out his framework for more quantitative easing. This speech triggered market expectations for the second round of quantitative easing (QE2) which officially began in November. QE2 was a response to weakness in the economy (which we wrote about in the June 2010 newsletter). It reassured the market that the Fed would bring on another round of quantitative easing to keep asset prices high and create a positive mood to encourage speculation and consumption. As the Fed intended, the result was a speculative boom in stock prices which seems to be based on the idea that the Fed has permanently for all time promised to keep printing money so that returns stay low and asset prices stay high.

A side effect of this shift into riskier assets was a decline in bond prices. Our Long-Term Value portfolio very slightly out-performed the S&P 500 index

over this period but the large chunk of client money in the bond market earned just 3%. The biggest drag on performance was our hedging portfolio which is designed to reduce our exposure to market "Beta" risk. An analysis of the underlying "factor returns" performed by Ned Davis research showed that the Market Beta factor had a 17.8% return over the last quarter. Other factors measuring riskiness also had relatively high positive returns. In contrast, returns to factors including Value Style and Profitability were negative over the quarter. If we look at a 10 year period, the ranking of returns to the various factors is reversed – valuation and profitability measures correspond with higher returns while risk factors correspond with lower returns. Although it's sometimes tough to accept under-performance in the short run, we keep our discipline and stick to the strategy that we know pays off in the long run.

Client returns data includes reinvestment of dividends after netting out fees and expenses. Note that our client portfolios are much less diversified than the S&P 500 index and therefore may exhibit higher short run volatility. Our view is that short run volatility is not an appropriate measure of risk of loss for long-term investors. Still, we have used hedging to reduce volatility over the last 3 years so as to avoid large unrealized losses which might cause clients to sell at the worst time. As a result the monthly volatility of returns for our portfolio over 6 years is lower than the S&P 500 (13.2% vs. 16.5%).

In summary, our clients have managed to outperform the market over the last 6 years while taking less risk. Although cumulative returns to date are somewhat unimpressive on an absolute basis, we expect market opportunities to improve as the Fed reduces its market interference.

Current Market Environment

QE2 is scheduled to end in June. In anticipation, interest rates are drifting up. When interest rates are rising in an over-valued, over-bullish market, we frequently see abrupt losses. In the short run we are maintaining a low risk profile to mitigate potential losses here. Because we think economic risks have subsided, we expect to be able to take more market risk in the near future even in the face of an overvalued market. The next section gives our thoughts on eliminating hedging in an over-valued market.

Hedging Valuation versus Economic Risks

In early 2008 as we saw the recession coming we implemented our risk reduction strategy which has included hedging against market wide moves. We did this primarily because we anticipated that the downturn in the economy would negatively impact the earnings and cash flows of the companies we owned and because we expected that market wide valuations would come down quickly when traders recognized the shift in fundamentals.

At this point, given the state of the economy and the valuations of our holdings, we can expect the fundamental earnings power of our investments will give us acceptable returns over a long enough investing horizon. On the other hand the overall market seems to have run up far beyond what is

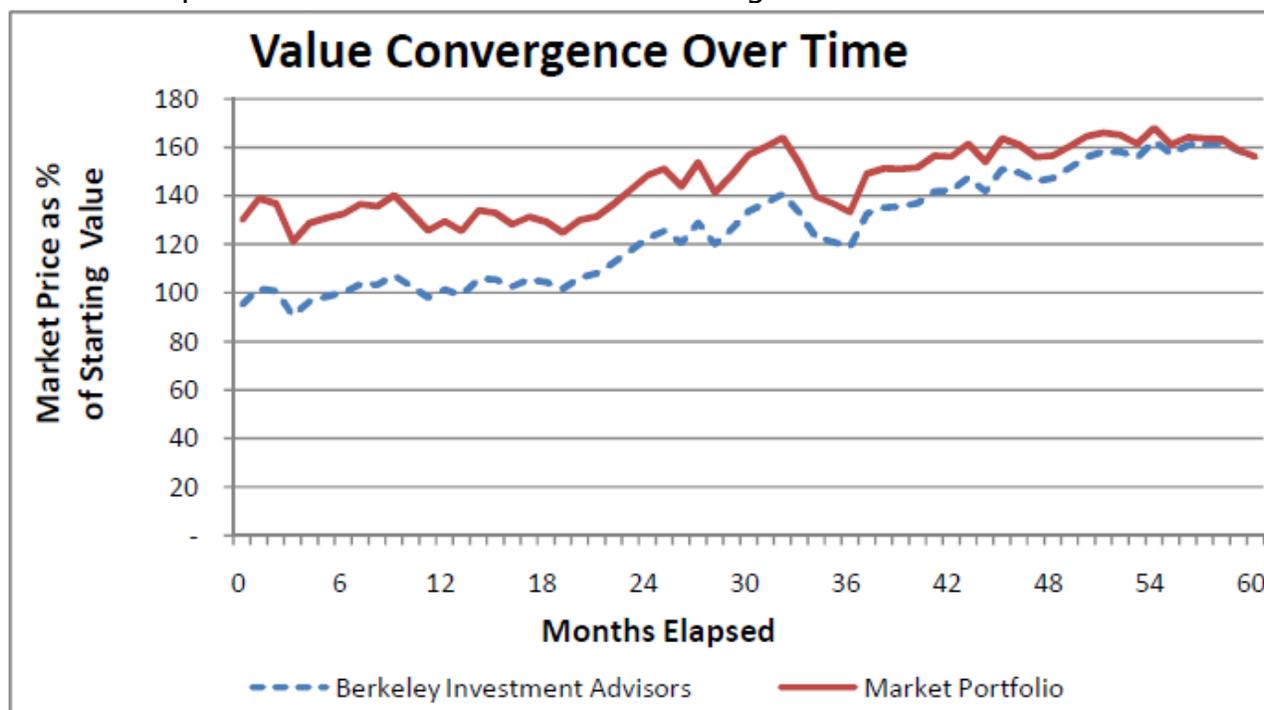
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reasonable for most stocks. This can be corrected over a short period as a market drop or it can be corrected over a long period if stock prices go up slowly and the fundamentals “catch up” over time. Since the late 1990s the market has demonstrated that it can remain over-valued for long periods. If prices do adjust suddenly, it will likely impact our positions as well - even if they are much cheaper on fundamental measures such as price to earnings ratio or price to book ratio. The table below illustrates the valuation differences:

Avg. Model Statistics	LT Value	S&P 500
Price/Earnings	11.1	14.9
Price/Book	1.4	2.0
Dividend Yield	2.63	1.87

These numbers are calculated by Folio Institutional - where most of our client accounts reside.

In the near future we will accept the potential for short-term fluctuations in order to allow for higher returns over the long run. Even though we feel the market is over-valued and priced to deliver low returns, we expect to earn good returns as the valuations of our stocks converge with the market through time. This process is illustrated in the following chart.



The idea here is that we can eventually eliminate hedges and accept the risks of short run market moves related to valuation and earn good returns even if the market is priced for poor returns. This chart shows how the market could

evolve over 5 years if the market is 30% over-valued at the start but our portfolio is 5% under-valued (relative to a true intrinsic value of cash flows). This chart assumes that the long run returns on stocks are 10% when correctly valued. In this scenario, the market portfolio earns just 3.7% annually over the 5 years for a cumulative gain of 20%; whereas our under-valued portfolio would earn 10.5% annually for a cumulative return of 65%.

The above analysis is meant to illustrate our point on valuation risks versus economic risks. There is no guarantee that we will see these kinds of returns over the next 5 years – though we certainly hope and plan to achieve such returns.

Current Investment Opportunities

In the last 3 years the domestic oil and gas production industry has been revolutionized by a new technology for drilling natural gas wells. One of the pioneers of this technique is a company called Chesapeake Energy (we own shares in Chesapeake). First they drill down into shale rock and then they drill horizontally. They then inject water and chemicals in a process called fracking which pushes gas through the porous rock and up the well. These wells produce much higher gas flows than conventional wells and therefore the returns on capital are much higher. Unfortunately the surge in production has driven down domestic natural gas prices from \$13 per 1,000 cubic feet in 2008 to around \$4 today. In the last year, the industry has discovered that this technology can also produce oil if you find the right geological formations. Many companies have rushed to lock up drilling rights on such lands and are just beginning the drilling process.

In an investor presentation by Rexx Energy (another of our holdings), they disclosed that the return on capital at current oil prices is 100% when drilling oil wells in the Niobrara formation using the horizontal drilling technology. This means that companies that have locked up land rights can earn up to 100% returns on incremental capital expenditures for years to come. The application of the technology to oil drilling will also benefit gas resource owners because the higher returns available in oil drilling is likely to substantially reduce the amount of new gas wells drilled and so eventually natural gas supply. The resulting higher natural gas prices will greatly benefit companies like Chesapeake Energy. There will be great investments in this area and we are actively looking for additional companies where the stock price is still low enough to get us good returns.

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