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Investment Newsletter – March 2016

This newsletter starts with a look at the tax planning choices when you have your own business and you are choosing among retirement account options: Cash Balance Defined Benefit, IRA, SEP-IRA, Simple IRA, 401K, and Roth accounts. If this is not of interest, skip to the end where we'll update performance of the Short Term Income strategy.

Small Business Retirement Account Tax Strategies

If you own your own small business, there are many options to consider in setting up retirement savings plans for yourself and any employees. These include:

1. IRA – regular Individual Retirement Account
2. SEP – Simplified Employee Pension Individual Retirement Account
3. SIMPLE IRA or 401K – Savings Incentive Match Plan for Employees
4. 401k –regular company group retirement plan - can do for 1 person
5. Roth accounts – an IRA or 401K can be set up as Roth type meaning contributions are not tax deductible and withdrawals will be tax free.
6. Cash Balance Defined Benefit – pension plan using benefit formula which depends on age, years of service, and percentage of pay.

Each of these has slightly different rules and so have advantages and disadvantages for different taxpayers.

The easiest and cheapest way to set up a tax advantaged savings plan as a small employer is for each employee to set up their own IRA and make their own contributions any time during the tax year or up until the deadline for filing taxes. These can also be set up as Roth accounts where you do not get to deduct contributions but you can take withdrawals without paying any tax – assuming you are at retirement age. Roth accounts also have an advantage over regular accounts because they do not have required minimum distributions. Note that no contributions are allowed to a regular IRA once the owner reaches age 70½.

If an employer sets up a SEP plan and there are employees other than the business owner, contributions to all employees' accounts must be made on the same basis. Employee contributions are not allowed. The employer may contribute up to 25% of each employee's pay with a limit per employee of \$53,000 for 2016. Contributions are deductible by the employer and not included in employee pay.

A SIMPLE plan is similar to a 401k in that it allows employees to have

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deductions taken out of their pay and contributed to the plan - thereby avoiding current taxation on the money contributed to the plan. These can be implemented as IRA accounts or as 401k plans but are subject to less complex rules than a standard 401k. Employees below age 50 at year-end may contribute up to \$12,500 in 2016. Employees over 50 can contribute an additional \$3,000. The employer must generally match employee contributions up to the first 3% of pay each year. Alternatively, the employer can elect to contribute 2% of each employee's pay irrespective of the employee's contributions. If you are a high income business owner with no employees this plan would not be a good choice, but it could be a good choice if you have employees.

The 401k plan is the standard defined contribution plan for corporate America but these plans have pretty complex regulatory baggage and they are more expensive to administer than the plans we've covered so far. The most likely scenario where such a plan makes sense for a small business owner is if there are no employees other than the business owners. In that case there are plans specifically tailored to the situation which are affordable - though still more costly than other plans. The single(k) plan from Theonline401k Company costs \$215 per year. They can handle plans with multiple employees, but fees are much higher. The contribution limits for 401k plans are larger than the other defined contribution plans. In 2016 the employee may contribute up to \$18,000, plus another \$6,000 if over age 50 by year-end. On top of that, the employer may contribute up to 25% of each employee's compensation - with a maximum of \$53,000 in 2016. Besides the high contribution limits, another advantage of the 401k plan is the ability to borrow against the account without penalties.

Roth accounts are retirement savings accounts where the contributions are not deductible but withdrawals (after retirement age) are not taxable. This could be an advantage in situations where current year income and tax rates are low relative to what is expected in retirement. Otherwise it will generally be better to convert regular IRA money to Roth accounts after retiring so that a lower tax rate is paid on money going into the Roth. The only accounts eligible for Roth treatment are IRA and 401k accounts - not SIMPLE or SEP plans.

Finally we come to the most complex option of all - the defined benefit plan. There are two types of defined benefit plans but we will only discuss Cash Balance plans because the old style traditional defined benefit plans are generally not a good choice for small businesses. Cash Balance plans are very similar to 401K plans in that each employee has an account balance. These are not actually separate accounts but rather accounting allocations within an overall plan. Each plan year, each participant's account is credited with a percentage of their compensation. The account balance is also increased by the plan's interest rate component - which can be a fixed or a floating rate. The company must contribute an amount to the plan each year equal to the sum of the increases in the participants' accounts. This amount is fully deductible against taxable income.

The big advantage of a Cash Balance Defined Benefit plan is that small business owners can design the plan benefit formula so that they defer a very significant portion of income into their retirement accounts while contributing to employee accounts at reasonable rates. This works best when there are few employees and the employees are significantly younger and/or have much lower

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compensation than the business owners. The amount that can be deferred this way is really only limited by the ability of the business to generate consistent profits so that the formula commitment can be funded over the long term.

The formula for accumulating the account balance must not discriminate against the non-owner employees. This test can be met if the full retirement age benefit for non-owners is at least as high as for owners – measured as a percentage of average salary over the time till retirement. This test can easily be met even if the owners are deferring a much larger percentage than employees so long as the employees have many more years to accumulate the account balance.

For example suppose the owner, who is 50 years old, pays himself \$200,000 per year and there is a 30 years old employee making 40,000. If full retirement age is 65, the owner has 15 years to accumulate the benefit while the employee has 35 years. If the interest rate in the plan were set at 4%, the plan could set a formula such that the owners account is credited with 35% of salary (= \$70,000) while the employee's account would get 10% of the employee's salary. Under this setup the employee would accumulate an account balance at age 65 equal to 7.37 times salary; the owner would accumulate an account balance of 7 times salary. Since the employee's benefit is a higher ratio of salary, the plan is not discriminatory. This result is driven by the additional years the employee has to accumulate the balance, combined with the interest to be earned over this period.

These plans result in very large tax deferrals during a business owner's highest earning years. Setting up and maintaining the plan is more costly than defined contribution plans: the plan must pay actuarial fees, administrative fees, and pension benefit guarantee insurance costs. Of course the taxes saved may far outweigh these additional costs if you own a very profitable business.

Each type of account has its advantages and disadvantages depending on the business owner's situation. The table below summarizes the key aspects.

	SIMPLE IRA	SEP-IRA	Regular IRA	401K	Cash Balance
Good points	Low cost to set up	Low cost to set up	Low cost to set up	Can do loans from balance	Largest tax saving
Bad points	High penalty if withdraw in 1 st 2 years	No Employee Contributions	Contribution limits	Complex. High cost to run.	Complex. Highest cost to run.
Employee Limit	12,500 + 3,000 if over 50	0 – Not applicable	5,500 + 1,000 if over 50	18,000 + 6,000 if over 50	0 – Not applicable
Employer Limit	Must match 1 st 3% of pay contributed or 2% of pay regardless of employee contributions*	Lower of 25% of pay or 53,000	0 – no employer contribution	Lower of 25% of pay or 53,000	No limit – depends on formula & participants
*Matching can be temporarily reduced in limited circumstances					

If you need advice on your situation please contact Berkeley Investment Advisors.

Short Term Income Portfolio Strategy and Performance

Berkeley Investment Advisors uses several different strategy portfolios to manage client assets. The Short Term Income portfolio is a fixed income portfolio that focuses on short to intermediate term rate maturity loans and bonds. Typically shorter maturity bonds offer lower interest rates (yields) than longer maturity bonds and are less sensitive to changes in interest rates. This category of fixed income includes securities with floating interest rates that can reset periodically depending on market conditions. For example the rate paid could be set based on the 3-month London Interbank Offer Rate (3-month LIBOR).

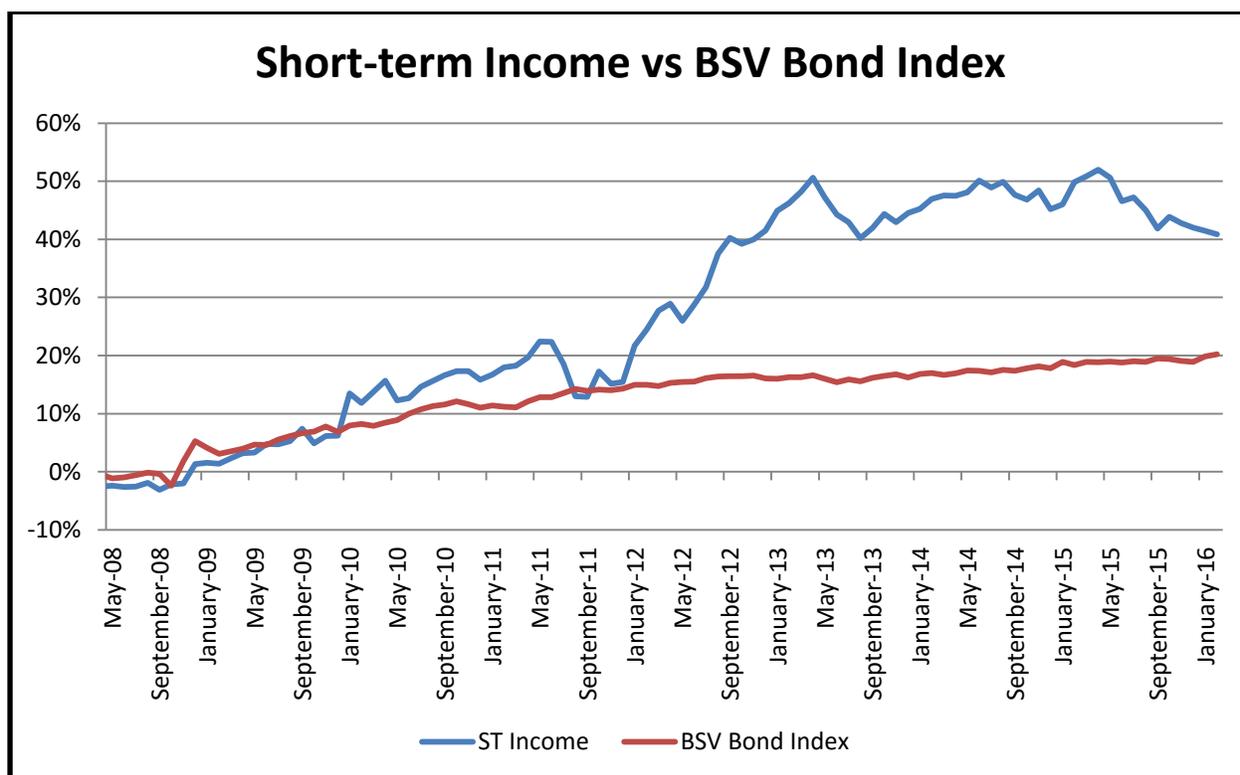
We measure interest rate sensitivity risk as duration. This tells us how big a change in price we can expect when interest rates change. Typically a short term bond fund strategy would own bonds with durations below 3. If we held a bond with duration of 3 when rates went up 1% we would expect the bond's price to decline by 3%. In the current environment where interest rates are historically low, we have chosen to keep portfolio duration to an even lower level – currently 1.2.

Besides interest rate risk, there is also credit risk in our bond portfolio – the risk that borrowers may default and not pay all that is due. Lower rated bonds, known as high yield or junk bonds have a higher probability of default than higher rated bonds but compensate by paying higher interest rates. In a sense, default risk is similar to equity market risk as it is correlated with the performance of the economy. Individual credit risk is managed by diversifying across a large number of issuers. In this way we insure that the extra premiums earned will not get wiped out by a few companies defaulting. Our strategy is to accept these credit risks to earn those extra returns.

Another source of incremental yield comes from buying closed end funds that have lower trading volumes than typical exchange traded funds. These securities can be bought at a discount to the underlying bond values (and sometimes sold at a premium). In addition these funds can enhance returns through embedded leverage at very low cost of funds - thereby enabling us to capture some of the borrowing benefits of the low rate environment. These borrowing rates will rise in the near term so the yield on this portfolio could drop initially as rates rise. In holding these securities we must endure more price volatility in down markets as retail investors tend to want to sell more at lows. Current market conditions are providing about 1.15% higher 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, including government bonds and mortgage backed securities. A good 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 short maturity U.S. bond market.

At least some clients have had money invested in this portfolio since it was created in February 2008. 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 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 above graph shows the cumulative return for the strategy from 2/29/2008 to 2/28/2016 as 40.9%. Thus the annualized compounded rate of return since inception (8 years ago) has been 4.38%. Up until April 2013 returns were much higher. Recent events have pulled returns below what I consider normal.

Returns by Year

Year	Short term Income	BSV Bond Index	Difference
1 3/2008 - 2/2009	1.4%	3.1%	-1.7%
2 3/2009 - 2/2010	10.3%	5.0%	5.4%
3 3/2010 - 2/2011	5.5%	2.7%	2.8%
4 3/2011 - 2/2012	5.5%	3.4%	2.1%
5 3/2012 - 2/2013	17.5%	1.1%	16.3%
6 3/2013 - 2/2014	0.5%	0.6%	-0.2%
7 3/2014 - 2/2015	2.0%	1.2%	0.8%
8 3/2015 - 2/2016	-6.0%	1.6%	-7.6%
8 Year Compounded Total	40.9%	20.2%	20.6%

The table and chart above show moderate volatility for strategy's returns. Although this strategy turned in its first loss in the last year, generally there is much lower risk of principal loss over a year's time than in other strategies - such as stocks or

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long term bonds. Relatively large allocations to this strategy should serve to reduce risk for clients when other asset classes have elevated risks. The stock market continues to look particularly risky using historical norms. We want to avoid large losses and have funds available to buy when the market returns to a lower level.

The relatively poor performance over the last 3 years has clearly been very uncomfortable so it's important to understand the context and the implications for the future. No one can accurately predict market returns – especially over short horizons but it's especially important not to extrapolate recent results into the future for fixed income strategies because returns tend to be mean reverting. High returns tend to be followed eventually by lower returns and vice versa.

All securities tend to have long run returns that are primarily determined by the valuation at purchase – meaning how much you paid relative the income produced by the security (yield for bonds, price to earnings ratio for stocks). We know going in what we're likely to earn on the securities – assuming we hold long term. Of course this is an averaging process over years as the market's moods will push returns up and down. For bonds, where most of the expected return is from interest payments, it's a bit like a spring. If you push it far enough down you are increasing the resistance to further downward pressure and increasing the distance that it will eventually spring back. To see why, consider the nature of the underlying securities. Returns on bonds come from their interest payments and changes in price. If you bought a bond at its face value¹ (also known as par value), your returns would be exactly the interest payments assuming you hold to maturity and the issuer does not default. Between purchase and maturity, however, changes in price will cause "mark-to-market" returns to deviate from the interest rate paid on the bonds because the account value will include both the cash payments of interest and the new value of the bonds assigned by the market at any given moment. These "mark-to-market" gains and losses will tend to cancel out over time because ultimately the bonds will mature and cash will be received and reinvested at the new interest rate then prevailing on new bonds. Let's consider a simplified example.

Suppose you have a bond that you bought for \$100 at the start of year 1. Suppose that it pays \$5 interest each year and then \$100 is paid back at maturity in 2 years. At purchase we know that the annual compounded rate of return will be 5% which is the \$5 per \$100 of face value that we are paid each year. This doesn't, however, mean our return over a holding period will be 5% because the price of the bond at the end of year 1 will be set by traders in the market. Suppose that bond traders decide they need a return of 10% to hold this bond in the second year. In that case they will set the market price at \$95.45 (calculated as $105/1.10$) at the beginning of year 2. If this happens your return on a mark-to-market basis would be just .45% in the first year. This is calculated as:
 $(\text{ending price} + \text{interest} - \text{purchase price})/\text{purchase price} = (95.45 + 5 - 100)/100$.
If you don't sell, your return in the 2nd year is 10% calculated as:
 $(\text{maturity value} + \text{interest} - \text{year 1 price})/\text{year 1 price} = (100 + 5 - 95.45)/95.45$.
So, if you pay attention to the market price in looking at your account you see a very low return the first year and a very high return the 2nd year. The overall return

¹ This is the amount the issuer promises to pay the bond holder at maturity.

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is still exactly the 5% per year that you accepted when you bought at the start. The same math works in reverse in the case where traders drive bond price up at the end of year 1: The year 1 return will be high and the year 2 return will be low.

If your purpose in investing is to earn cash returns to spend in retirement then these “mark-to-market” gains and losses are almost irrelevant. I say almost because they do not change the cash flows that you bargained for when you bought the security but changes in market rates will impact you when maturity cash flows are reinvested in new bonds. In this case lower bond prices and higher future returns are unambiguously good for investors. This would be the silver lining to recent poor performance in the bond strategies. Unfortunately, it’s more likely that bond prices will go right back up before there is much chance for maturing bond proceeds to be reinvested at higher rates. This brings me to another important point about investing.

It is well known that many (probably most) investors do not achieve the returns that they should because there is the tendency to sell when the “return spring” has been compressed to the bottom and future returns are poised to recover a recent downturn. Likewise, people want to buy when the spring has stretched upward - when they should be just holding or even paring back. A substantial part of the value of an advisor is that we can help you to resist this source of long term return erosion so that you can earn the returns commensurate with the original purchase price. In my opinion the next 3 years will produce much higher returns than average and make up for the past 3 years – even if the bond spring just returns to neutral.

Having covered the big picture, let’s explore some of the technical factors underlying recent performance. There are two main factors that drove this result. The closed-end funds in the portfolio suffered significant declines in investment income over the period. They had been distributing capital gains as interest rates declined (prices move opposite of yields). Eventually they ran out of capital gains and the replacement bonds were purchased at lower yields. Thus the decline in investment income is the delayed result of declining interest rates (and increasing bond prices) from the big market moves in 2012 to 2013.

The second factor in low recent returns is the recent rise of risk premiums for high yield bonds – which pushes high yield bond prices down. The index of high yield spreads went from 4.98% at 2/28/2013 to 7.75% on 2/29/2016. The median spread since 1996 is 5.21%. Only about 18% of the time since 1996 has the spread been larger than where it ended up on 2/29/2016. These adverse market conditions reversed the flow of retail investor dollars. A rush into closed-end funds in 2012 reduced the typical discounts to fund net asset values. This produced a 17.5% return in the 5th year of the Short Term Income strategy. Since 2013 the pendulum has swung back. Fund discounts versus underlying bond values have widened substantially, in many cases moving more than 10% – thus reducing our returns on a mark-to-market basis relative to the bond market.

There is one position in the portfolio which deserves a special mention: Brookfield Total Return Fund. This particular security was singled out by a well known bond investor in a Barron’s article on savvy investment ideas on 1/23/2016. Before the article it was selling at a 14.4% discount to net asset value. Two days later the discount was down to 5.9% and by the end of February the discount was

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just 1.8%. Recently it is trading at a premium. This was our largest position but it has been slowly sold down as it moved to a premium.

The bottom line to this story is that after two years of depressed returns the closed-end funds (except for the one position mentioned above) are trading at relatively large discounts to the underlying bonds. This should support better returns going forward. In fact all the negative trends noted above reversed in March and the portfolio is up 5.6% for the month. At March 31 2016, the weighted average discount on the closed end fund positions in the portfolio is now 6.1%. This average discount is skewed low by the one position that is trading at a premium which we trading (slowly) for discounted securities. Looking at just the other positions the average discount is about 7.3% - still high relative to the average since 2007. Overall the current portfolio yield before fees is 6.63%.

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