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Investment Newsletter – March 2018

This quarter we will discuss three major economic factors driving market moves in early 2018 – tax law changes, rising interest rates and trade tariffs. But before we get to that, we'll update the performance of the Short Term Income strategy and look at where things stand with some of the underlying market factors that influence returns on this portfolio.

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). This rate, in turn, changes as the Federal Reserve Bank raises (or lowers) it's "Fed Funds Rate".

The interest rate risk sensitivity risk of the portfolio is measured by its duration. 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 and on the way up, we have chosen to keep portfolio duration to an even lower level – currently 1.4.

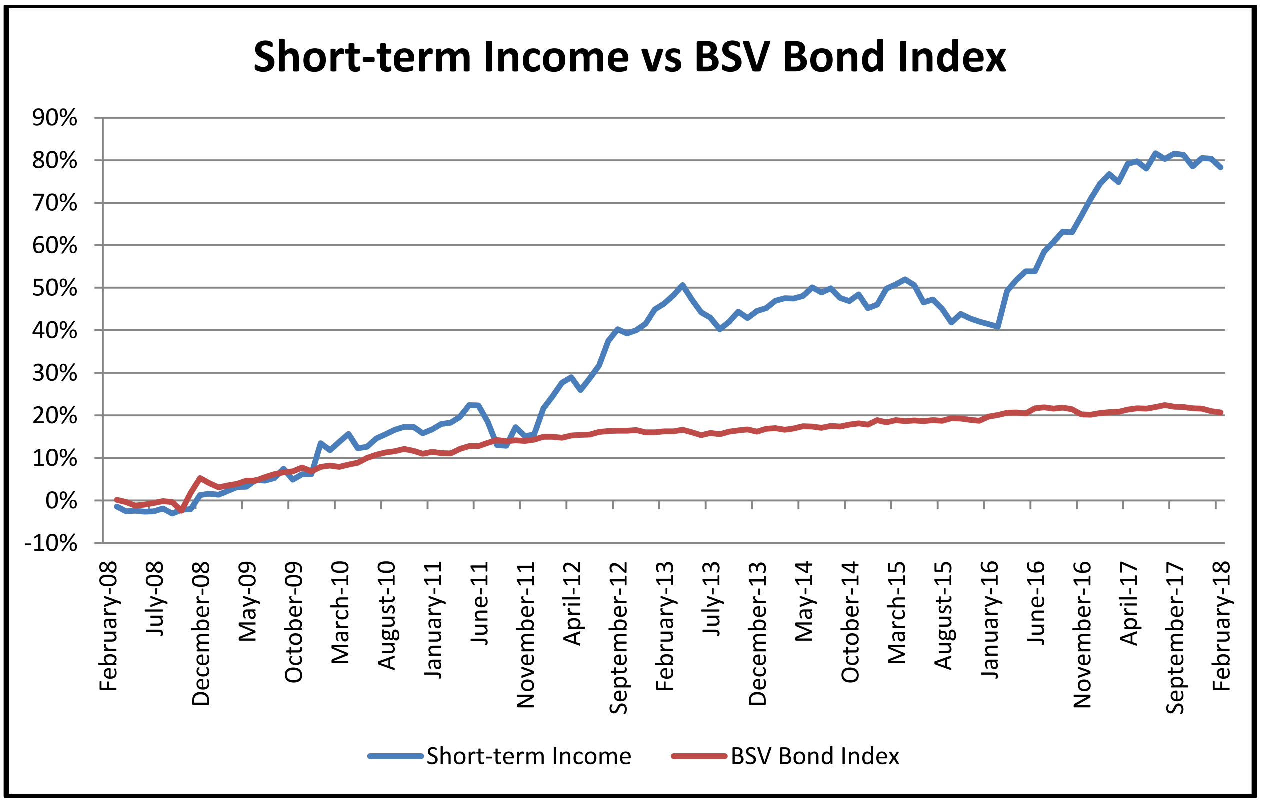
There is also credit risk in our portfolio –borrowers may default and not pay all that is due. High yield bonds have a higher probability of default than investment grade rated bonds but these lower rated bonds compensate by paying higher interest rates. It is this spread compensation that fluctuates depending on the market's current risk pricing attitude (mood). This pricing risk is related to equity market risk and it is also correlated with the performance of the economy. We manage individual credit risk by diversifying across a large number of 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. 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 .80% 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. 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.

At least some clients have had money invested in this portfolio since it was created in February 2008. The graph below 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.



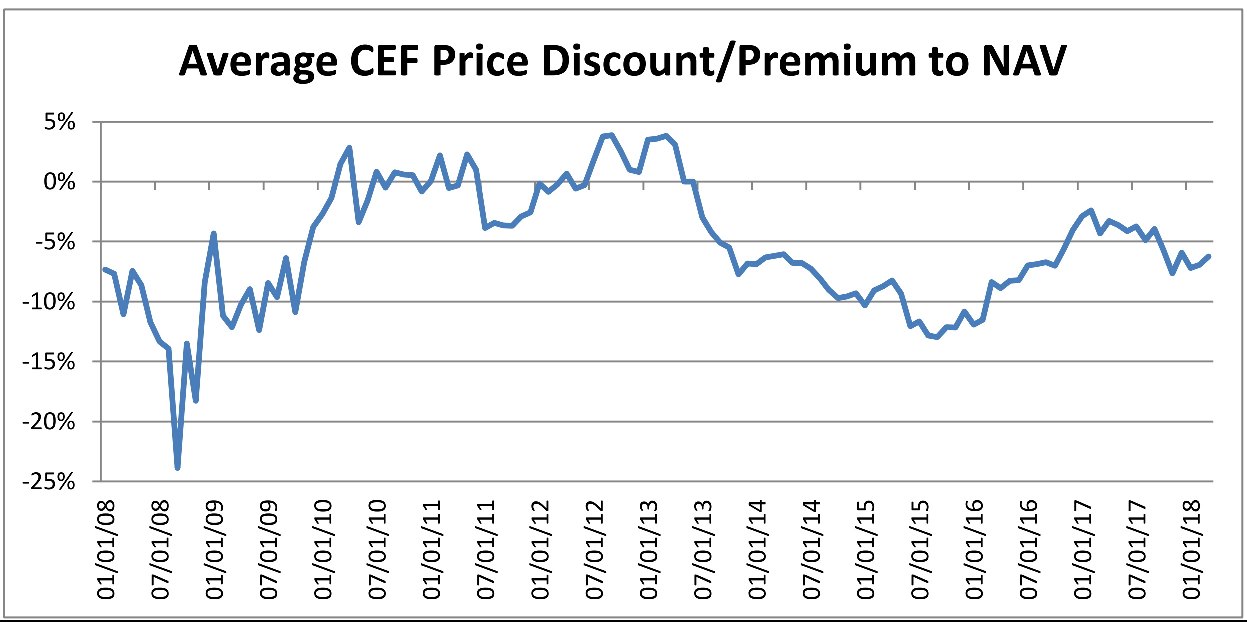
The cumulative return for the strategy from 2/29/2008 to 2/28/2018 is 78.3%. **Thus the annualized compounded rate of return since inception (10 years ago) has been 6%.**

The graph shows moderate volatility for the strategy's returns. Although this strategy did incur a minor loss in its 8th year, generally there is much lower risk of principal loss over a year's time than in other strategies - such as stocks or 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 table below breaks down the portfolio returns by year since inception.

Returns by Year

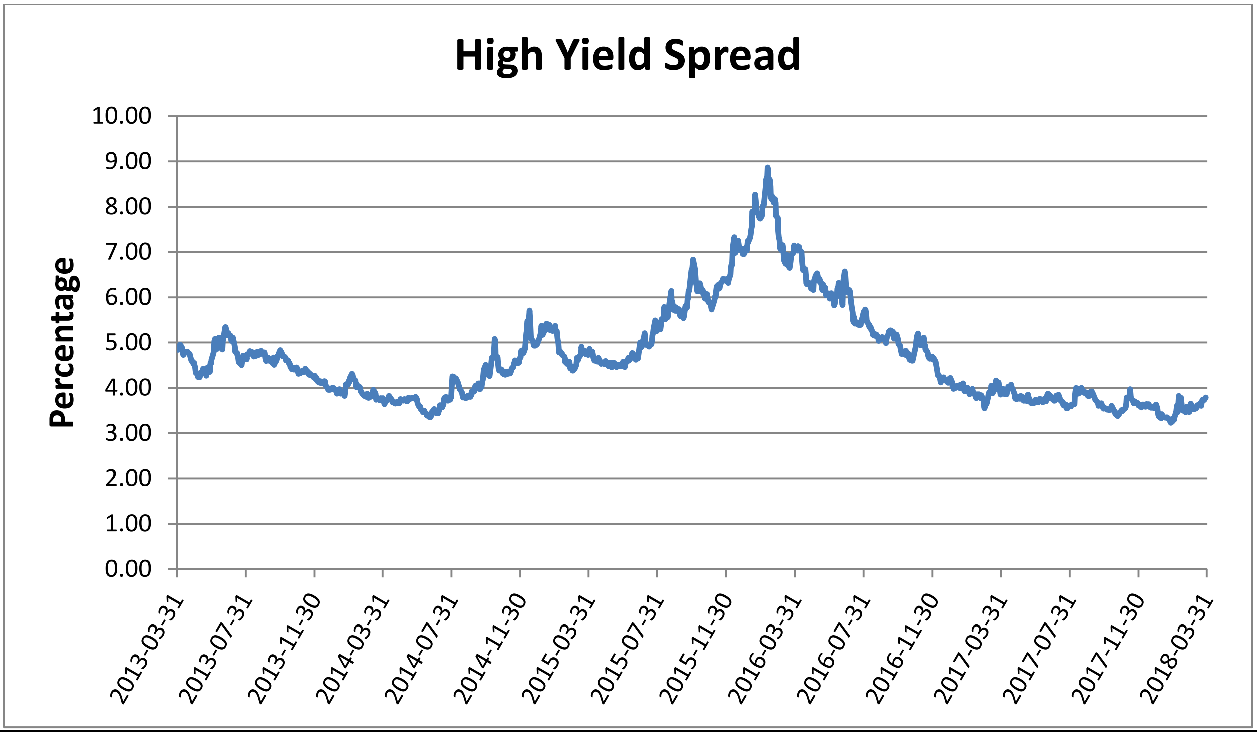
Year	Year Ended	Short term Income	BSV Bond Index	Difference
1	2/28/2009	1.4%	3.1%	-1.7%
2	2/28/2010	10.3%	5.0%	5.4%
3	2/28/2011	5.5%	2.7%	2.8%
4	2/29/2012	5.5%	3.4%	2.1%
5	2/28/2013	17.5%	1.1%	16.3%
6	2/28/2014	0.5%	0.6%	-0.2%
7	2/28/2015	2.0%	1.2%	0.8%
8	2/29/2016	-6.0%	1.5%	-7.4%
9	2/28/2017	25.5%	0.6%	24.9%
10	2/28/2018	0.9%	-0.1%	1.0%
	Compounded Total	78.3%	20.7%	57.7%

Up until April 2013 returns were quite good but then market conditions pulled returns below normal for the next 3 years. By February 2016 the market for these securities was extremely undervalued based on several indicators. One of these indicators is the level of closed end fund discounts. Below is an update of the usual chart showing the time series of an average of 7 CEFs we've tracked since 2008.



The average discount for CEFs as shown in the chart on the prior page is 6.06%. For these CEFs discounts had mostly turned to premiums by April 2013 and then descended back to very wide discount levels by February 2016. Subsequently discounts have moved back toward the average and now stand at 6.25%

Spreads on underlying high yield bonds also fluctuate depending on the economic outlook and investors' attitudes towards default risk. The chart below shows the Bank of America High Yield Spread index over the last 5 years.



In this chart, higher spreads indicate lower bond prices (and higher forward yields). Thus the spike up to a spread of 8.87% in February 2016 implies a decline in market values of high yield bonds. This combined with the widening of CEF discounts to produce a negative return for the strategy that year. This spike was somewhat usual and represented a buying opportunity. The median spread over this past 5 years has been 4.5%. Spreads are currently at 3.79% because of the very strong economic outlook. This is exactly where they were 4 years ago.

Over the year ended 2/28/18 the average CEF discount in the previous chart increased from 2.4% to 6.9% over that period. At the same time the net asset values of our positions also declined. Decreasing fund asset values and increasing discounts offset most of the interest collected for the year, leaving us just a very slight net return.

Various positions have been bought and sold throughout the year. The weighted average discount for CEFs currently in the Short Term Income portfolio is 9.4%. In recent months, the portion of the portfolio invested in high yield securities has been reduced to lower market risk. This has lowered the portfolio yield slightly. Overall the current portfolio yield before fees is 6.53%. Over the next year, we can expect increases in interest payments from the underlying floating rate loan securities as the Federal Reserve increases interest rates. Increases in high yield spreads are also likely.

The Implications of Lower Taxes, Rising Rates, and Rising Tariffs

The new tax law for 2018 reduced federal corporate tax rates from 35% to 21% and changed the U.S. to a territorial system whereby profits earned outside the country are no longer subject to U.S. tax except when profits are attached to movable assets which the government wants to discourage companies from moving to tax havens. For domestic businesses their new tax rate is just 60% of the prior amount. This change creates significant incentives for investing in U.S. businesses and on its own would produce increased growth in income and profit margins.

This increased growth profile for the economy in the face of low unemployment significantly increases the probability of higher inflation in the near term. In addition the higher growth forecast should naturally lead the Federal Reserve to raise interest rates faster than they otherwise would. As a result benchmark 10 year treasury interest rates increased by about .5% at the beginning of the year. This translates into higher rates throughout the economy. Higher rates will counter-act some of the positive impact of tax cuts on profit margins and investment. It is unlikely that a .5% rate move is enough to offset the positive effects of the tax cut on domestically focused companies.

Demand for California housing is likely to be negatively impacted by both the tax law and the increase in mortgage rates. For the portion of the population that works and buys houses using mortgage debt, after-tax costs will rise substantially. Interest will be deductible only on the first $750,000 of a purchase mortgage and the combined deduction for state income tax and property tax will be limited to $10,000. If you make enough money to qualify for a 750,000 mortgage then your state tax is already at or very close to the deduction limit. Therefore very little, if any of property tax will be deductible. Also, because the standard deduction was raised to $24,000, the first $14,000 of interest expense ($24,000 – state tax of $10,000) won't reduce taxable income. For a house costing $937,500 purchased using a $750,000 mortgage, the tax change alone will increase the net cost of a house by about 11%. Adding in the extra cost of the .5% increase in mortgage rates and the total rise in cost for this example house is 14% compared to 2017. The increase in costs for houses above this price level will be even higher. This comes on top of the 10.2% rise in San Francisco house prices themselves in the year ended January 2018 – according to the Case-Shiller index. Combining it all, annual out of pocket house purchase costs are up more than 25% in 12 months. In recent years money has been no problem for home buyers in the Bay Area. This is most likely because rapidly rising incomes, generated in the technology sector, have been driving demand. At this point, any weakening in technology sector payrolls or equity compensation is likely to show up in housing prices (with a lag of 6 to 12 months).

President Trump was elected on a platform of protecting U.S. workers from unfair trade deals. It looks like 2018 will be the year he takes action to reduce imports. So far very little has been implemented, but there is a significant likelihood of tariffs against Chinese imports this year. In return, China will impose tariffs against U.S. imports. In 2017 we imported $505.6 billion worth of goods from China and exported $130.4 billion. So far, the president is talking about tariffs on only $50-60 billion worth of goods. Total U.S. gross domestic product in 2017 was $19,739 billion - so the portion of goods in the economy likely to be effected is less than 1%. In general, a rise in import barriers should tend to raise inflation in the near term. Export barriers put up by other countries in retaliation could slightly reduce economic growth. The growth effects of the tax cuts and the recent federal spending increase should greatly outweigh any negative impact from trade. But combined trade barriers, increased federal spending, and reduced tax rates should drive a modest increase in inflation.

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