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Investment Newsletter – September 2013

Again this quarter monetary policy has dominated all else in driving markets, so this newsletter will review the economic impact that has become visible since long term interest rates started rising in the second quarter. This informs our analysis of the Fed's "surprise" decision to maintain their bond buying program at the same pace.

We will then review returns and strategy of The Long Term Income portfolio - the first individual strategy portfolio for which return calculation are complete.

Interest Rates and The Federal Reserve Bank's Dilemma

While the Federal Reserve Bank's quantitative easing (bond buying) program does not directly stimulate the economy, it does seem to have been the catalyst for the powerful rebound in housing prices. The bond buying has reduced mortgage payments and increased household wealth, thereby increasing consumers' ability and willingness to spend more. Lower rates can also ease car payments; auto sales have boomed.

In the June newsletter we noted that mortgage rates had increased by 1.11%, thereby increasing payments on a given mortgage by 11% or reducing the affordable mortgage by 11%. Because buyers generally lock in rates two month before they close a purchase, the soonest we could see any market impact would be pending home sales for July and actual sales in late August or early September. Nationally, seasonally adjusted pending home sales dropped 1.6% in August. According to the California Association of Realtors pending home sales in July slipped by .2% from June and were down 1.5% versus last July. Dataquick reports closed sales in the Bay Area for August dropped 7.7% from July but just .4% from last August. So we are seeing the beginning of a slowdown in volume. It's too soon to expect any reduction in prices, but the Federal Reserve (the Fed) knows quite well that the rate increase has stalled the momentum of the housing market and that this driver of economic growth may be lost over the next few months.

The apparent goal for the Fed in slowly reducing (tapering) bond purchases was to gradually allow interest rates to return to normal levels set by the market. The key term is slowly because a spike in rates, such as we've seen, has the potential to significantly slow economic growth. Recent statements and actions of the Fed make it clear that the market's rate move generated by their <u>talk</u> of tapering went farther and faster than the Fed intended for the actual implementation. Thus they decided to undo the "taper" before it had begun. Their hope is that long term interest rates will come back down and they can achieve the slow and modest rise they intended rather than the large and rapid rise they triggered by talking of reducing bond purchases.

It seems that the Fed's problem is the role of expectations in the market. Researchers inside the central bank and elsewhere believe that the market's expectations about the future path of short term interest rates is a far bigger factor in keeping long term rates low than the Fed's $85 billion per month bond purchases. They therefore concluded that announcing a slight tapering in the rate of bond purchases should have only minor impact on long term rates as long as the Fed kept promising to keep short term rates low for a long time. Bond traders reason that a slowing of bond purchases leads to a stop of Fed purchases in less than a year and eventually sales of their now massive holdings. This means bond prices will have to go down and yields up. Once that expectation becomes consensus the prices and rates will move early as traders try to get out early and buy back after the price drop. Therefore if the Fed wants to reverse some of this reaction they will need to convince the market that there is no timeline for selling the bonds or at least introduce enough uncertainty to get some players to buy bonds now rather than waiting for a price drop to come from Fed selling.

Update on the Federal Reserve's Losses

In the June 2012 newsletter we did a rough estimate of the Fed's losses in May to June which came out to $210 billion. These losses are offset against prior unrealized gains before they begin to offset the bank's capital. The Fed issued their second quarter financials last month showing that the unrealized loss for the quarter (including an offsetting gain in April) was roughly $150 billion. With this information and a detailed look at their balance sheet at the end of the last two quarters, we can revise our estimate of the duration of their portfolio to 6.9 (we previously used 9.25).

The bank's unrealized gains remaining at June 30th were $33.9 billion. The value of their securities portfolio was $3,560 billion. Since then rates have risen another .09% which implies additional losses of $22 billion (= .09% * 6.9 * 3,560). Therefore we can expect that as of this quarter, interest rates would need to rise .18% higher to exhaust the remaining unrealized gains plus $32.1 billion of their capital. Of course the Fed need not be too concerned about unrealized losses. They can always hold till maturity if they need to do so.

Market Moves

In the third quarter, the 10 year Treasury bond yield rose an additional .09%. The yield actually rose .46% to its high point on Sept 5th before falling back. As explained in the last newsletter, rises in such interest rates will tend to push down all bond prices with longer term bonds experiencing greater losses than short term bonds. In addition, discounts from asset values in the closed-end fund sector continued to increase - pushing up yields relative to Treasuries. This discount widening was enough to offset interest income in the quarter, but losses were much smaller than in the 2nd quarter. As of 9/30/13 the yield on the Long term income portfolio has reached 8.21% (before fees) and Short term income is at 6.81%.

In the equity market, interest sensitive sectors were very volatile and ended mixed. Property REIT's were down 2.9%, mortgage REIT's were down 2% (though our positions were up) and utility stocks were roughly flat since June. Although we have not calculated our own numbers, according to Folio Institutional, our Long Term Value portfolio outperformed the S&P 500 index by roughly 3.3% before fees in the third quarter as our positions rebounded from the sell off in the 2nd quarter.

Because of the historically poor return versus risk on offer in the stock market, most of our clients have very large allocations to fixed income so as to maximize returns while avoiding the possibility of major capital losses. As a result we have seen account values drop even while the equity market marches to new highs. In the short run this is painful to watch but there is a silver lining.

The Flip Side of Bond Price Declines – Rising Reinvestment Returns

It seems counterintuitive but if our investment horizon is long enough (meaning longer than the maturity of our bond holdings), dropping bond prices and rising bond yields will actually benefit us in the end. Because bond prices don't affect bond cash flows, a bond investor is still entitled to receive the same cash returns over the life of each bond holding. If you are reinvesting those cash flows in new bonds at now higher yields, you end up with higher ending wealth than if bond prices had remained as they were. This is why I was very enthusiastic in the last newsletter about mortgage REIT's. The rise in yields on their reinvestment opportunities will enable them to maintain higher dividends than would have otherwise been possible. This "reinvestment" effect was very apparent when I recently recalculated a client's retirement capital forecast using lower account balances, but higher bond interest rates. Looking out beyond 5 years or so, projected capital is higher and grows faster than under the prior interest rate scenario. While rising rates are detrimental to the economy in the short run, they will be good for investors in the long run. In fact, without this rise in rates, the underfunded defined benefit pension plans run by most government entities (and unionized industrial companies) would be in far worse shape. These institutional investment plans need a much higher return environment to avoid big shortfalls. We have already seen several large municipal bankruptcies that are at least partially due to unfunded pensions that suddenly require much more cash than thought because of the Fed's repression of interest rates. The message here is look to the long run when investing!

Long Term Income Portfolio Strategy and Performance

Berkeley Investment Advisors uses several different strategy portfolios to manage client assets. The Long Term Income portfolio is a fixed income portfolio that focuses on intermediate to long term maturity bonds. Typically longer maturity bonds offer higher interest rates (yields) than shorter maturity bonds and are more sensitive to changes in interest rates. 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 long term bond fund strategy would own bonds with durations above 8 given that 10 year treasury bonds have duration of 9.25. If we held a bond with duration of 8 when rates went up 1% we would expect the bond's price to decline by 8%. In the current environment where long term interest rates are historically low, we have chosen to keep duration to a lower level – currently 4.6.

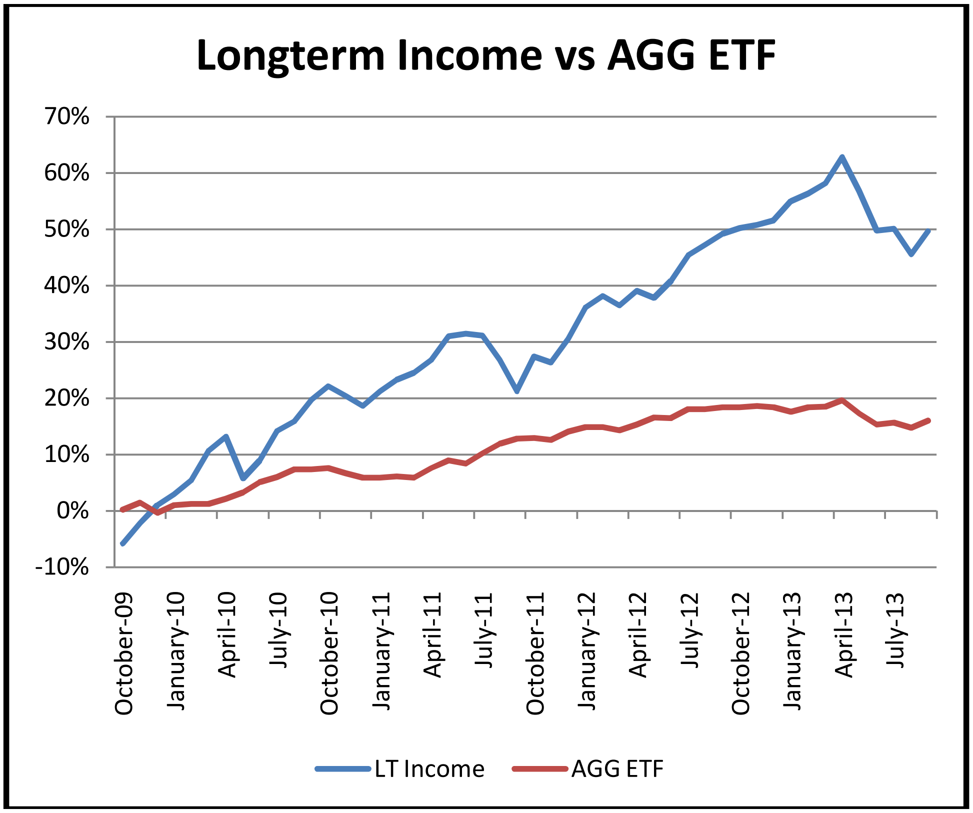
Besides interest rate risk there is also credit risk in our bond portfolio – the risk that borrowers may default and not pay all that is due. Lower rated bonds, known as high yield or junk bonds have a higher probability of default than higher rated bonds but compensate by paying higher interest rates. 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. Given that the weakest credits defaulted during the last recession and the overall low level of interest rates, the return versus risk trade off has been very favorable in lower rated bonds. 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 rate subsidy targeted at banks by the Federal Reserve. 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 1.2% 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. Aggregate Bond Index as represented by the iShares Core Total U.S. Bond Market exchange traded fund (ticker AGG). This is meant to represent the total overall U.S. bond market.

Although we first created this portfolio in February 2008, it was not continuously invested until September 2009. Therefore we cannot calculate performance further back than the last 4 years. 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 AGG). 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.

	Returns by Year		
Year	Long term Income	AGG Bond Index	Difference
1	19.8%	7.4%	12.4%
2	1.2%	5.0%	-3.8%
3	23.1%	5.0%	18.1%
4	0.2%	-2.0%	2.3%
4 year compounded total return	**49.6%**	**16.0%**	**33.6%**



Thus the annualized rate of return over 4 years has been 10.59% despite the dramatic pullback from the high hit in April this year. The table and chart above makes it clear that the strategy exhibits significant volatility in returns with the most recent year returning only .2% (after fees).

Future Returns Expectations

My expectation is that current bond yields and prices are at sustainable levels – at least for the economic environment over the next 3 to 4 years. Therefore I don't expect to see the high returns we had in years 1 and 3, nor the low returns we had in years 2 and 4. Of course, anything can happen but it seems reasonable to expect annual returns in the range of 6.5% to 7.5% (net of fees).

In contrast, long term forecasting models, which have been validated with historical data, are projecting forward 10 year returns below 3% for the S&P 500 stocks. This is because of the elevated valuation levels we're at now; an article in today's Wall Street Journal pointed out that equity valuations are currently 47% above the long term average (based on cyclically adjusted price to earnings ratios). Of course the equity market is not predictable, but better buying opportunities are very likely rather than a slow steady climb at 3% annually.

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