



Licensed by the California Department of Corporations as an Investment Advisor

## **Investment Newsletter – September 2015**

---

This newsletter starts with an update of the performance of the Long Term Income strategy, including an updated analysis of the underlying market factors that have caused recent losses in the portfolio. This discussion of the bond market's move towards risk aversion and increasing risk premiums sets the stage for a commentary on market cycles, valuations and the price of risk, which concludes the newsletter.

### **Long Term Income Portfolio Strategy and Performance**

Berkeley Investment Advisors uses several different strategy portfolios to manage client assets. The Long Term Income portfolio focuses on intermediate to long term maturity bonds. Longer maturity bonds provide higher interest rates (yields) than shorter maturity bonds and are more sensitive to changes in interest rates. A bond's interest rate sensitivity risk, known as its duration, 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, but we have chosen to keep duration lower – currently at 3.8. If we hold a bond with duration of 4 when rates went up 1% we would expect the bond's price to decline by 4%.

By reducing duration of the portfolio we are reducing risks because there is an unusual amount of uncertainty about the future course of interest rates. Except for government bonds, interest rates have been rising for some time – meaning bond prices are declining and future returns are rising.

Besides interest rate risk, there is also default risk in this portfolio. Bonds with a higher probability of default (relative to other corporate bonds) compensate investors with higher interest payments – hence they are called high yield bonds. High yield bond default risk is like stock market risk - it is correlated with the performance of the economy. At the portfolio level we diversify away individual company default risk by diversifying across a large number of issuers. This insures that the extra premiums earned won't be lost due to a few companies defaulting. Our strategy is to accept market correlated credit risks to earn those extra returns.

The extra return on high yield bonds over the interest rate paid by the U.S. treasury is called a credit spread – it is the compensation that investors demand for taking credit risks. These spreads change according to investors' risk preferences – i.e. how much they need to get paid for taking credit risk changes according to market mood just like stocks. Therefore by accepting default risk we also accept

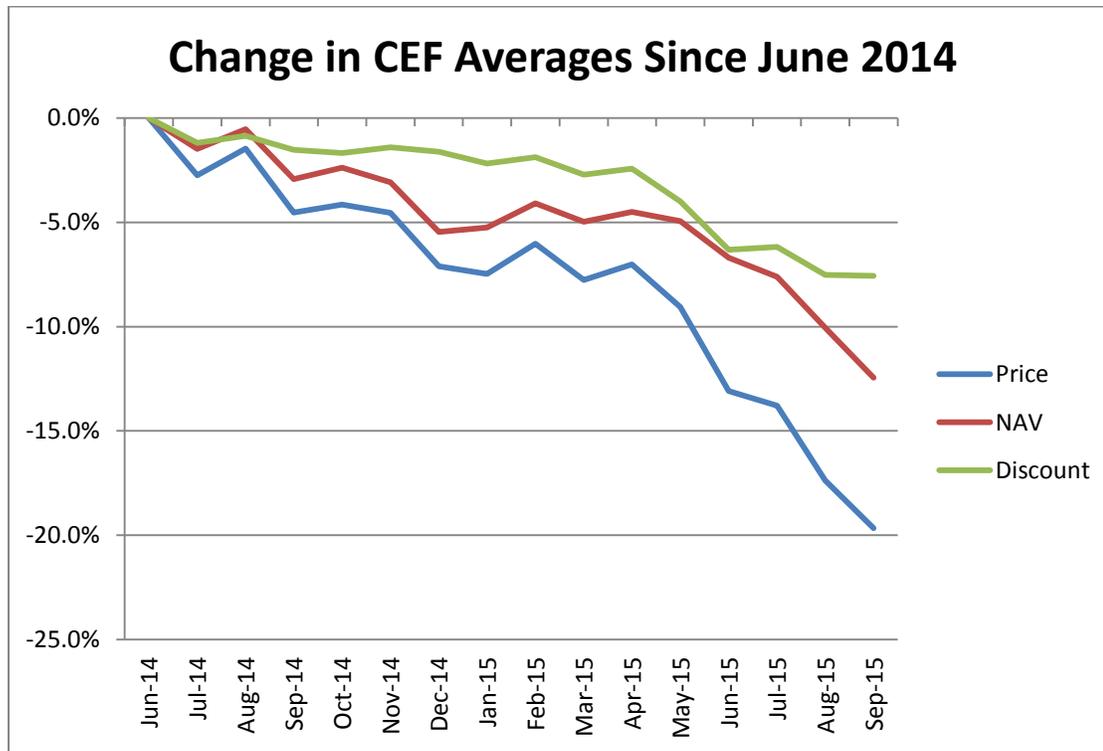
Berkeley Investment Advisors  
Investment Newsletter – September 2015

---

credit spread “pricing risk” and we must endure fluctuations in our portfolio value the correspond to market risk seeking or risk aversion (moods) – but at roughly half the level of stock market moves.

We also pursue incremental yield by buying closed-end funds (CEF). These securities can be bought at a discount to the underlying bond values (and occasionally sold at a premium). These funds also enhance returns through embedded leverage. Using these securities means we must endure more price volatility in down markets because most retail investors want to sell more at lows. Current market conditions are providing about 2.5% higher yield on our portfolio than if we held the underlying bonds directly. This is an unusually large advantage which is driven by historically large discounts on our closed end funds relative to bond values. We previously discussed this issue in our June 2015 newsletter and we will provide an update here.

The portfolio’s returns are impacted by changes in CEF prices relative to the underlying bonds. To determine the impact we can look at monthly prices and net asset values (NAVs) for our largest CEF holdings. NAV represents the value of underlying bonds inside the closed end funds and the difference between price and NAV is the discount that funds trade at relative to value. The chart below provides information on the relative impacts of underlying bond price declines and the widening of CEF discounts (from NAV). Specifically the chart below shows cumulative changes as a percentage for the average of 5 CEFs over 15 months. Note that the depreciation in prices is partially offset by interest we received, thereby dampening return volatility – but not eliminating it.

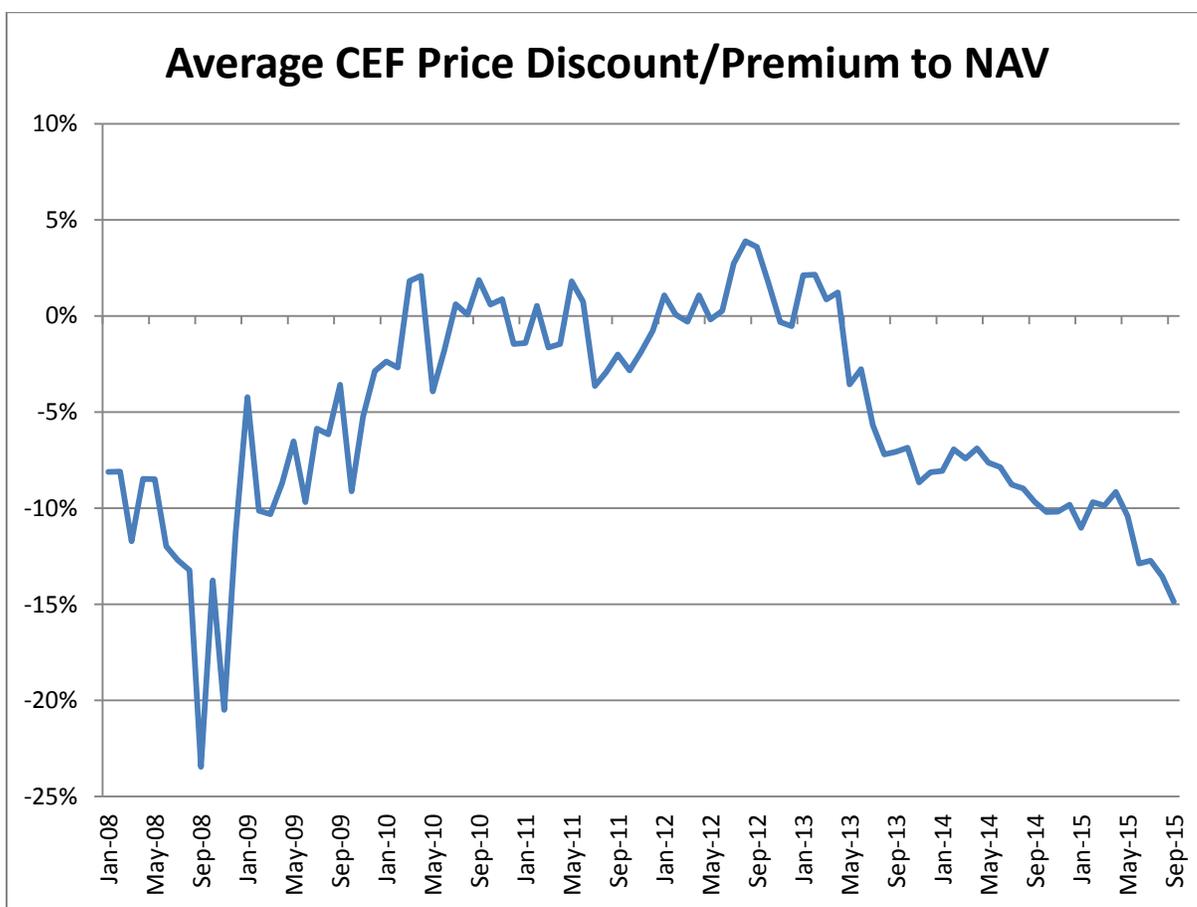


The chart shows the underlying down trend in NAV/bond prices (the red line in the middle). These price declines are not the result of changes in Treasury

interest rates but rather they are changes in the bonds' credit spreads – investors have become more risk averse since June 2014 and are therefore requiring higher future returns to buy risky bonds. Since June 2014 an index of high yield credit spreads has moved from 3.53% to 6.60%. Most of this shift has come in the last 4 months. Such changes in required returns are now beginning to show up in stock prices – the major stock indices have declined over the last 4 months.

The chart on the prior page shows that the fund prices dropped 19.7% in the last 15 months as compared to a drop of about 12.5% in the underlying bond prices (NAVs). Discounts widened by about 7.6%. This reflects a retail investor base that tends to react (or over-react) to market news more strongly than institutional investors in both up and down markets. Discounts are now at extreme levels. As the Wall Street Journal reported last Saturday, CEF discounts haven't been this large since the depths of the financial crisis.

To get an idea of how much CEF discounts can vary, I pulled data on a group of 4 CEFs with data available back to the beginning of 2008. These CEFs are included in both the Long Term Income portfolio and the Short Term Income Portfolio. The chart below shows the average discount for these 4 CEFs at the end of each month.



We see above that at the worst of the financial crisis, panicked investors were willing to sell CEFs at more than 20% below the underlying bond values (NAV). After the “weak hands” were taken out, these CEFs traded within 5% of NAV

Berkeley Investment Advisors  
Investment Newsletter – September 2015

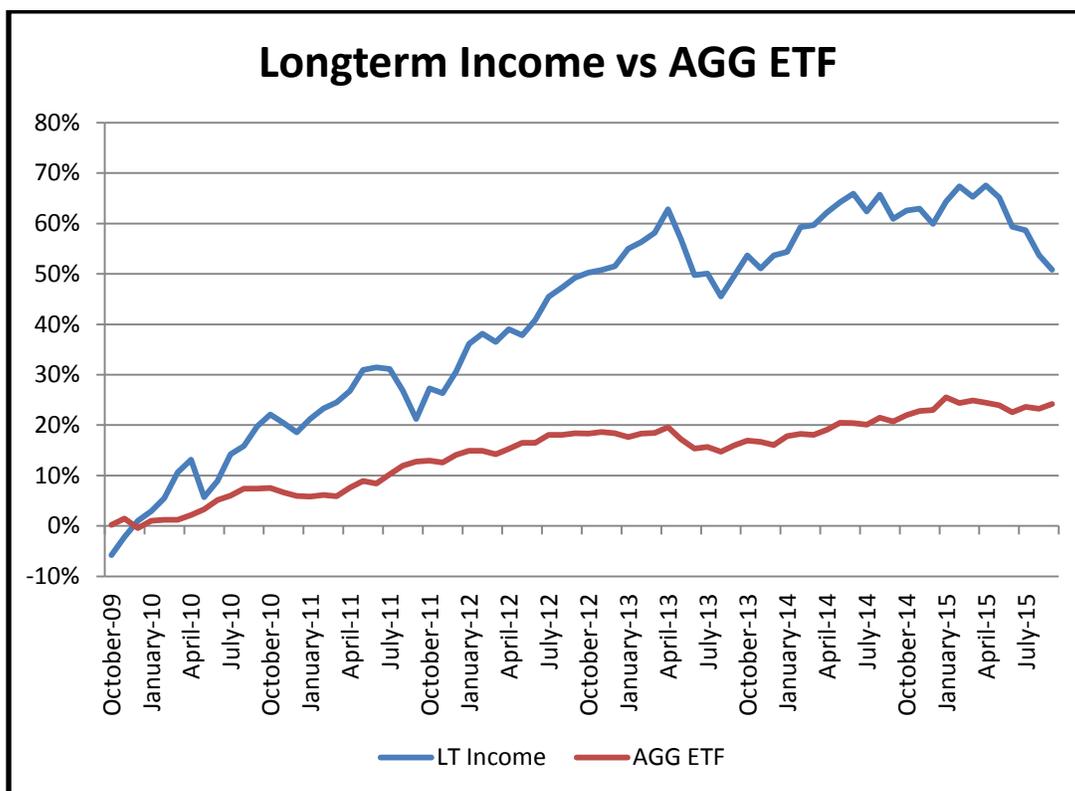
---

from 2010 to June 2013. You may recall that the bond market experienced the “taper tantrum” in mid 2013 when the Federal Reserve started talking about ending the quantitative easing policy. Bond prices dropped significantly and that volatility again caused CEF investors to sell at wider discounts. The discounts have been drifting lower since then and the drop accelerated in May of this year. I would interpret this as a shift towards greater risk aversion by retail bond fund investors. Because there is more uncertainty around interest rates and credit spreads, CEF buyers are requiring higher future returns to compensate for these risks.

The chart on the previous page looks ugly to us as holders of CEF investments because it means the value of our portfolio is going down. But it is worth remembering the flip side: we should now expect to earn higher returns going forward which will reverse these losses.

The Long Term Income 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 6 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).



Berkeley Investment Advisors  
Investment Newsletter – September 2015

---

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%
5	7.6%	4.1%	3.5%
6	-6.3%	2.9%	-9.2%
6 year total	50.8%	24.2%	26.6%

Total return over 6 years is 50.8% - an annualized compound rate of return of 7.1% - despite the dramatic pullback of the last 5 months. The table above makes it clear that the strategy exhibits significant volatility in returns and the current year is by far the worst ever.

The market goes through cycles of risk seeking and risk aversion whose timing is unpredictable. These cycles drive shorter term returns in stocks and bonds. While we cannot know the timing of any particular cycle, we can be confident that the market will eventually swing the other way. Although market momentum may still take prices down a bit more from here, my expectation is that we've seen the worst of the risk re-pricing in bonds. High yield bonds are priced to deliver higher returns than the major stock indices over the next few years.

As of quarter end, the yield on the Long Term Income Portfolio is 9.5%. This seems more than enough return for the risks. As I write this newsletter, our average CEF discount is more than 15%. I expect CEF discounts to move back below 10% within the next 2 to 3 years. If this happens, returns on the Long Term Income portfolio are likely to exceed 10% annually. Of course such an outcome would merely get us back to where we would have been without this cycle of increasing risk aversion and market volatility.

### **Market Cycles, Valuations, and the Price of Risk**

As discussed above, bond market investors have been shifting towards greater risk aversion and re-pricing credit risks for the last 15 months. The recent decline in the stock market also represents a re-pricing of equity risk premiums. If we consider that future cash flows to stock investors (i.e. dividends and stock buy backs) change very slowly, then changes in the price paid today for stocks must directly impact the rate of return on those stocks over the long run. Price increases reduce future long run returns and, conversely, price declines imply higher future returns. Therefore if investors demand higher returns for risk, then stock prices must go down.

Berkeley Investment Advisors  
Investment Newsletter – September 2015

---

Valuations at purchase (meaning prices as multiples of earnings and cash flows) determine long run returns because shorter term market fluctuations related to sentiment tend to cancel out over a long enough holding period. On the other hand, short run returns are determined by changes in investors' required risk premiums. A sudden re-pricing of risk due to a shift in market sentiment manifests itself as a drastic fall (or rise) in stock prices in the absence of fundamental changes in earnings power. The media looks to explain these price declines with reference to some event such as poor economic performance in China, or whether the Fed raised rates or not. The reality is that there need not be any particular reason.

Over time, as valuations rise and expected returns decline, more and more investors will decide that future returns offered by the market have gotten too low for the amount of risk in the world. Eventually these sellers overwhelm price insensitive buyers. When that happens there can be very large drops in securities prices until the decline in values raises future expected returns to the point where enough price sensitive investors are satisfied (with the risk versus return relationship) to stabilize prices. Berkeley Investment Advisors is one of those investors waiting for the market to offer better returns before accepting more risk. As better investment opportunities present themselves (via declining prices) we are ready to shift from low risk assets - but only when we can find investments where the returns are commensurate with the risks.

**Contact Information:** [RayMeadows@BerkeleyInvestment.com](mailto:RayMeadows@BerkeleyInvestment.com) 510-367-3280