Berkeley Investment Advisors

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Investment Newsletter – September 2024

Executive Summary

Long term interest rates peaked last October, three months after the Federal Reserve's last short term interest rate increase of this cycle. As longer-term interest rates declined since then, both our Real Estate and our Long-Term Income portfolios had large "bounce back" years. We now see the mirror images of the losses incurred during the rate increase cycle - which had pushed most asset prices down. Returns exceeded 20% for both strategies over their last year. The Fed's rate reduction cycle will also reduce the costs of leverage in closed end funds going forward and thus should increase income on funds investing in fixed rate securities.

Real Estate Portfolio Strategy and Performance

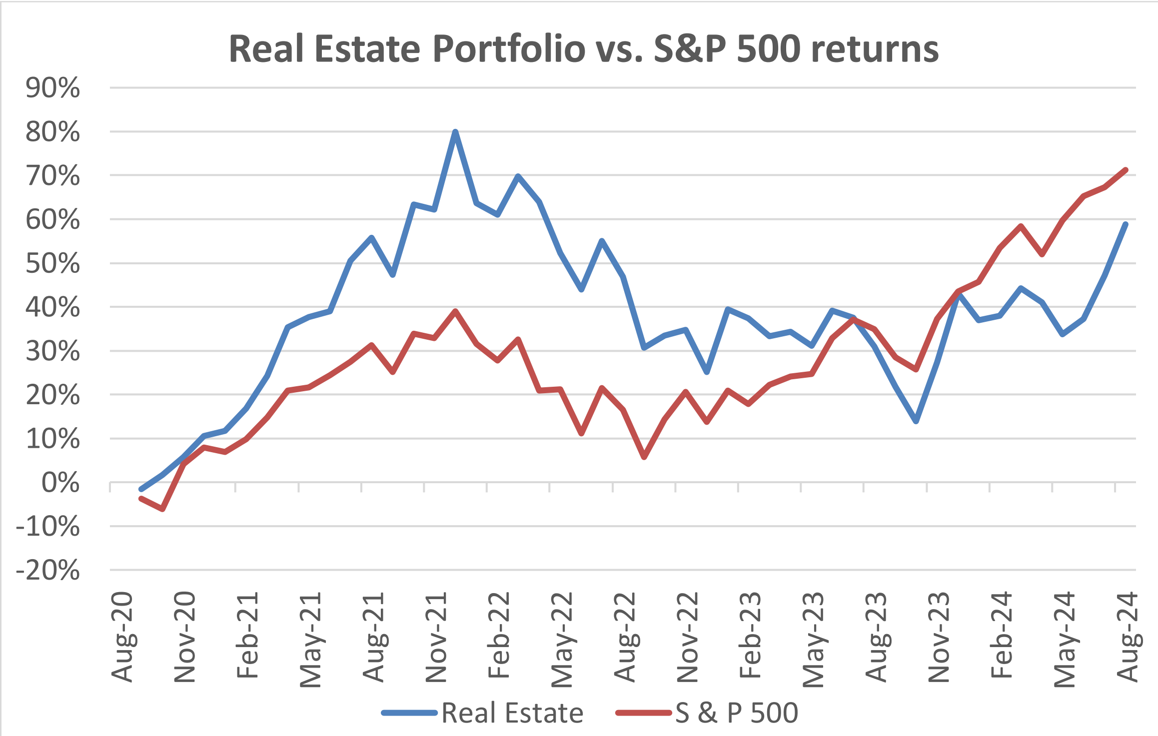
The Real Estate portfolio was launched August 31st 2020 based on my expectations for a surge of inflation resulting from the pandemic's impact on production, and the government's large handouts designed to stimulate demand. In order to provide an investment protected against higher inflation, the portfolio was allocated 60% to residential REITs, 26% to self-storage REITs, and the remainder invested opportunistically in other real estate securities.

Currently this portfolio provides a dividend yield of 3.1% and that income gets favorable tax treatment as Qualified Business Income.

The results for the first year of this portfolio were spectacular. The total return, including dividends, capital gains, and price appreciation, was 55.7%. The portfolio peaked at the end of 2021 with a cumulative return of 80%! In 2022 it fell roughly in line with the overall market as the Federal Reserve pushed up inflation adjusted (i.e. real) interest rates. I expect this portfolio to generally have a bit less downside risk than the S&P 500 index, but the huge spike upward in December 2021 added a mean-reversion effect on top of the 2022 decline in the overall market. Rising interest rates continued to hurt the market value of the portfolio through October 2023. After that, the Federal Reserve signaled they were done raising interest rates and the portfolio began to recover.

The rapid run up in rents for apartments slowed considerably in 2023. Low interest rates in 2020 and 2021 spurred a large increase in apartment construction. Deliveries in 2023 and 2024 are depressing rent growth. However, the pipeline of new units will slow going forward; I expect rent growth to resume. Meanwhile changes in interest rate expectations are the main driver of the portfolio.

The graph below shows monthly cumulative returns for the first four years in comparison to the S&P 500 stock index.



In 2023, and up to July 2024, the S&P 500 market index pushed higher based on a small number of stocks related to artificial intelligence technologies. This trend appears to stalled as the market assesses the imbalance between investment and profitability in this area.

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 are shown in the table below.

Returns by Year

Year	Year Ended	Real Estate	S & P 500	Difference
1	8/31/2021	55.7%	31.2%	24.5%
2	8/31/2022	-5.7%	-11.2%	5.6%
3	8/31/2023	-10.8%	15.8%	-26.7%
4	8/31/2024	21.2%	26.9%	-5.7%
	Compounded Total	58.8%	71.2%	-12.5%

The Real Estate portfolio performed poorly in its 3rd year, losing 10.8% while the S&P 500 gained 15.8%. This was bad enough to more than eliminate the very significant out-performance of the Real Estate portfolio in its first two years. Over the last year, the portfolio returned 21.2 % but still managed to lag behind the S&P 500. Over four years, the annual return of the portfolio is 12.3% versus 14.4% for the S&P 500.

The annual return is quite good given that the portfolio has lower risk than the S&P 500 at this point. Also, I still see significant inflation risk going forward and therefore this portfolio provides a way to mitigate this risk.

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 taxable intermediate to long-term maturity bonds and preferred stocks. Normally, longer maturity bonds provide higher interest rates (yields) than shorter maturity bonds and are more sensitive to changes in interest rates. The current environment is unusual in that short term rates are higher than longer term 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. The duration of the portfolio is currently at 4.8 (it was 4.0 last year). If we hold a bond with duration of 5 when rates went up 2%, we would expect the bond's price to decline by 10% (multiplying the rate increase by the duration).

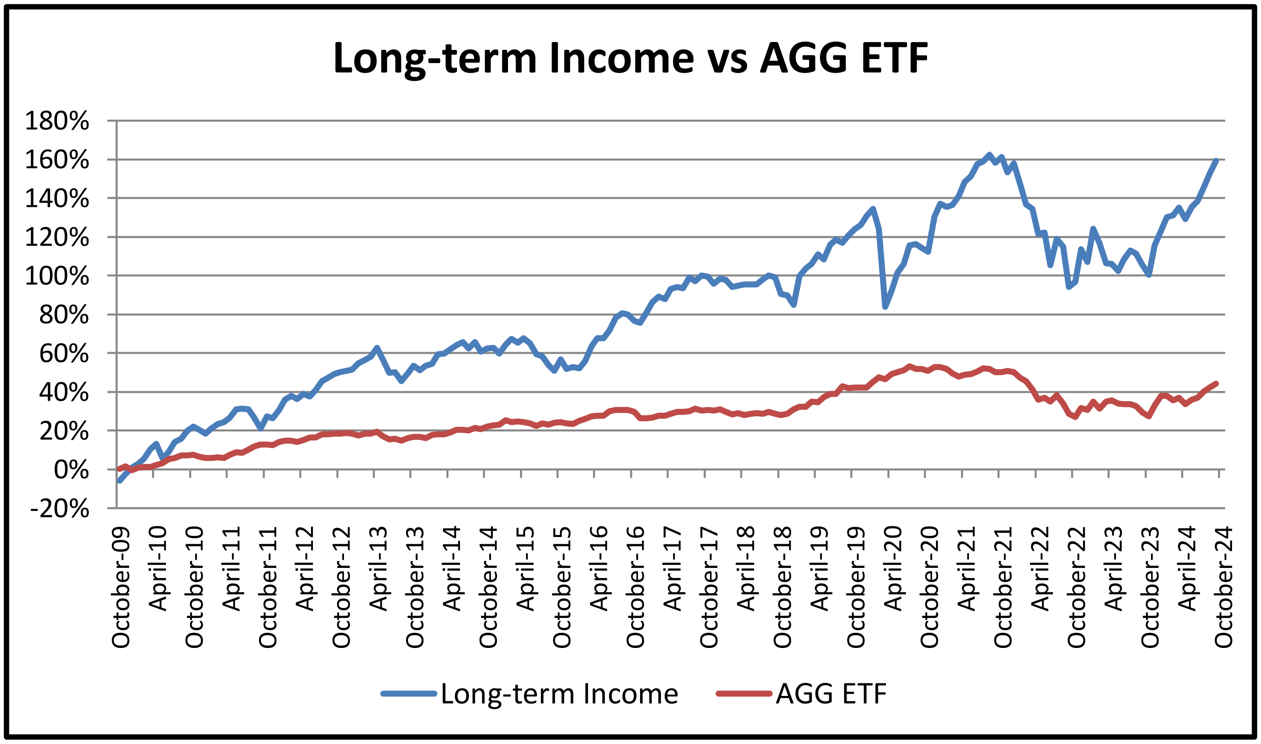
Besides interest rate risk, there is also default risk in this portfolio. Bonds with higher probabilities of default (relative to other corporate bonds) compensate investors with higher interest payments – hence they are called "high yield" bonds. High yield bond default risk is like stock market risk - it is correlated with the performance of the economy. At the portfolio level we diversify away individual company default risk by diversifying across many issuers. This ensures that the extra premiums earned will not 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 credit spread "pricing risk" and we must endure fluctuations in our portfolio value that correspond to changes in the market mood - risk seeking or risk aversion– but at roughly half the level of stock market moves. Because current spreads are low relative to the probability of recession in the next 12 months, the portfolio has a lower-than-normal allocation to high yield securities.

We generally earn incremental yield by buying closed-end funds (CEFs). These securities can usually be bought at discounts 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. Because leverage costs have increased significantly, the advantages of closed end funds are lower than under more normal market conditions. Current conditions are not providing any additional yield on our portfolio than if we held the underlying bonds directly, though we do benefit more from price gains as yields decline.

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.

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 graph above 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 AGG). Over the last year the portfolio return was **26.4%** compared to **11.6%** for its bond index benchmark (AGG). It was basically the mirror image of 2022. The total return over fifteen years was 159.4% - an annualized compound rate of return of 6.6%.

The Long-Term Income portfolio has experienced extremely high volatility in the last 3 years as interest rates have moved very fast and erratically thanks to the uncertainties around the path of inflation and Federal Reserve interest rate policies. The strategy has always had significant volatility in returns, but, prior to the surprisingly fast interest rate increasing campaign of 2022, the results have been good over periods longer than one year. The variation in yearly returns is driven mostly by changes in the market value of securities which I refer to as the "mark-to-market return". Long run returns, however, are driven mainly by the interest payments from the securities as the gyrations in market valuations tend to cancel each other out over a period of years. In last year's newsletter I suggested market conditions were very favorable for the portfolio and I thought it had a chance to outperform equities. I was correct about the favorable returns, but equities have surprised by producing even higher returns (by advancing to the richest valuation ever seen).

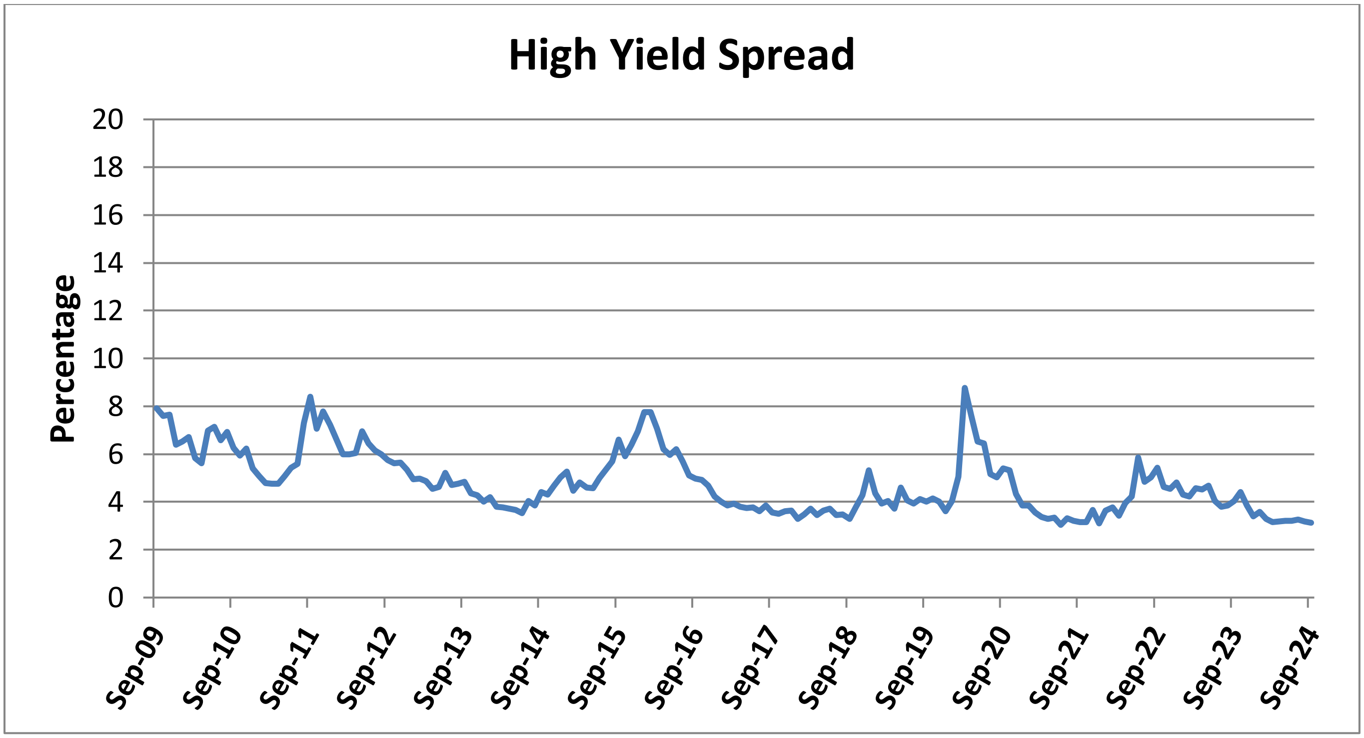
Returns by Year

Year	Year Ended	Long-Term Income	AGG Bond Index	Difference
1	9/30/2010	19.8%	7.4%	12.4%
2	9/30/2011	1.2%	5.0%	-3.8%
3	9/30/2012	23.1%	5.0%	18.1%
4	9/30/2013	0.2%	-2.0%	2.3%
5	9/30/2014	7.6%	4.1%	3.5%
6	9/30/2015	-6.4%	2.9%	-9.3%
7	9/30/2016	19.4%	5.2%	14.2%
8	9/30/2017	11.3%	-0.1%	11.3%
9	9/30/2018	-0.5%	-1.3%	0.8%
10	9/30/2019	10.9%	10.3%	0.6%
11	9/30/2020	-2.9%	6.8%	-9.8%
12	9/30/2021	20.5%	-1.0%	21.4%
13	9/30/2022	-24.9%	-14.5%	-10.4%
14	9/30/2023	5.8%	0.5%	5.3%
15	9/30/2024	26.4%	11.6%	14.8%
	Compounded Total	159.4%	44.3%	115.1%

For the year ended 9/30/2024 the interest rate on 10-year treasury bonds decreased from 4.52% to 3.79%. I estimate that this interest rate decrease increased the market value of the portfolio by around 2.9% compared to last year (4.0 average duration times the .73% interest rate decrease). Remember our portfolio value moves in the opposite direction of interest rates.

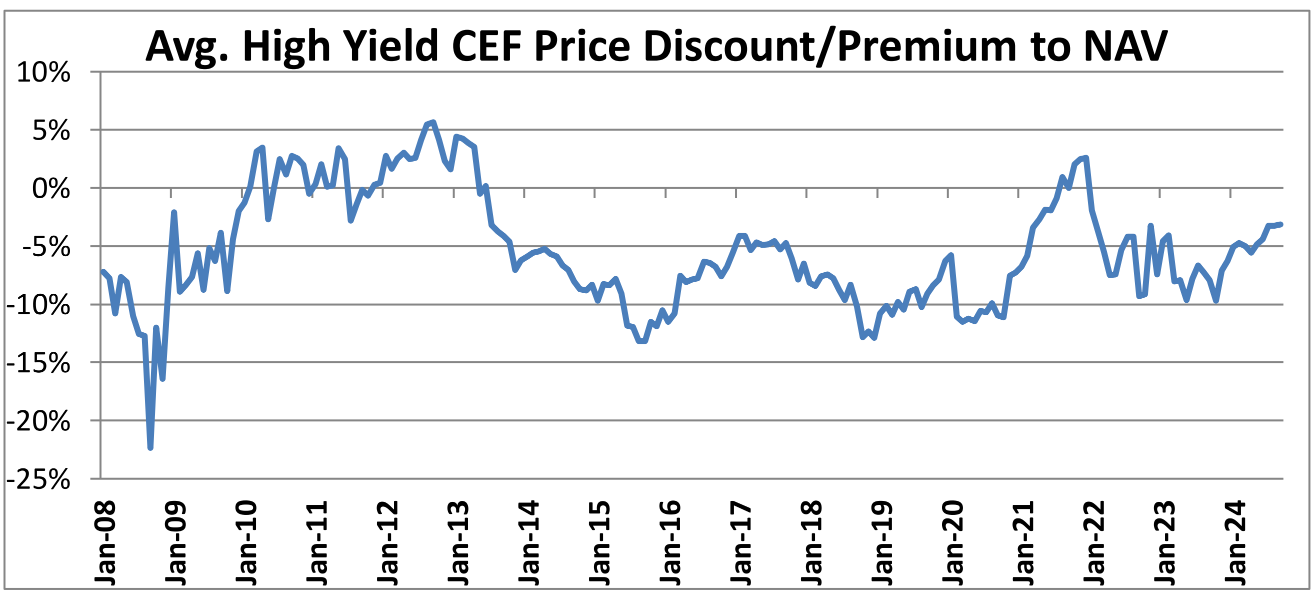
The graph on the top of the next page shows credit spreads over the last 15 years. The median spread over this period is about 4.6% and spreads gyrate around this central tendency, driven by market sentiment. The current spread of 3.14% is .89% lower than last year. I estimate that the decrease in credit spreads contributed approximately 3.6% to the appreciation of the portfolio over the last year.

The current high level of interest rates above inflation (i.e. real interest rates) normally would increase the probability of recession and financial distress, but the economy has been surprisingly resilient over the past 2 years. In my view there are two root causes keeping the economy growing in spite of higher interest rates. One is the slow unwinding of the labor shortage brought on by the Covid epidemic. It has taken businesses longer than normal to get back to comfortable staffing levels, and for the rate of quitting to move back towards normal. Second, both businesses and consumers locked in fixed interest rates when they were much lower so that the rate increases after 2021 apply to a relatively smaller part of the economy. Thus, spreads have declined because bond investors have re-assessed these reduced impacts of higher rates on employment and economic growth.



The portfolio's price returns (i.e., not counting interest payments) can also be 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 some representative 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.

To get an idea of how much CEF discounts can vary, I pulled data on a group of 8 CEFs with data available back to the beginning of 2008. See the graph below.



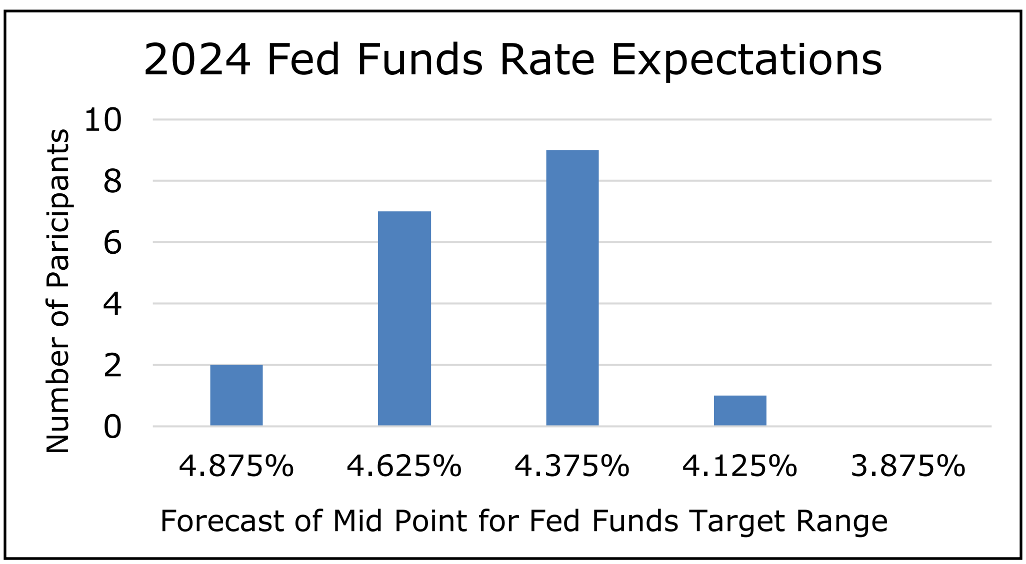
These CEFs have been included in either the Long-Term Income portfolio or the Short-Term Income Portfolio. The chart above shows the average discount for these eight CEFs at the end of each month. We see that discounts last bottomed at 9.7% in October 2023 and then climbed back. In the previous cycle they reached a slight premium at 8/31/2021 before reversing back. Currently this measure is at 3.1%. None of these funds are currently in the Long-Term Income portfolio. The actual average discount in the portfolio dropped from 12.1% last year to 3.9% this year. This drop of 8.2% was a big contributor to the return over the last year.

In the year ended September 2023 preferred stock part of our portfolio was marked down in price because investment grade fixed income spreads jumped after a series of bank failures. These markdowns were reflected in last year's high average CEF discount. In the current year, this markdown was reversed. An index of investment grade preferred stocks returned 11.5% over the last year.

As of 9/30/24, the underlying yield on the funds in the Long-Term Income Portfolio is 6.3% (before fees). From these levels, the portfolio offers acceptable expected returns for this market environment and its much lower risks as compared to large cap U.S. equities. It may under-perform equities over the next year, but if the economy does slow down, due to the lagged effect of high interest rates, this portfolio should do very well relative to equities.

Implications of Federal Reserve Interest Rate Cuts

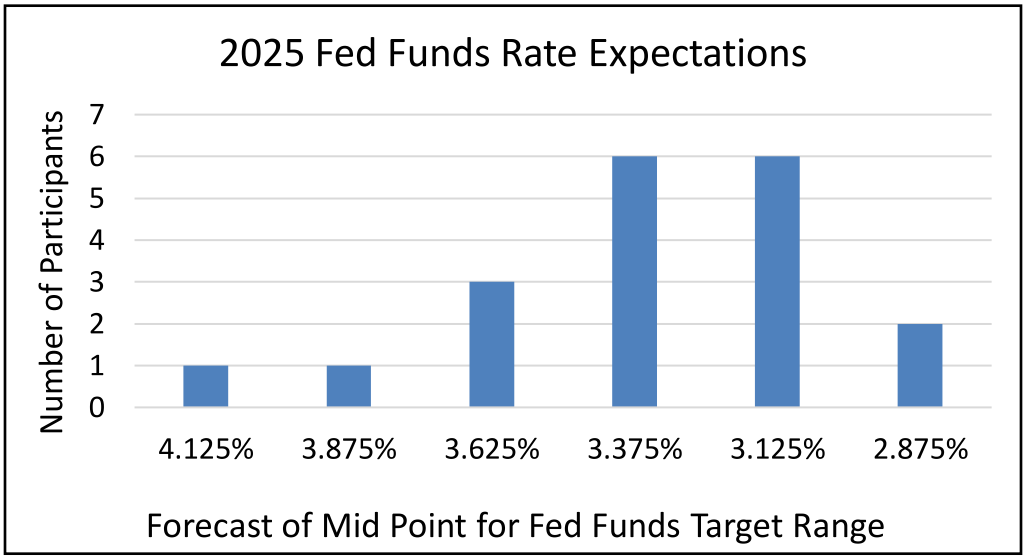
In their meeting this month, the Federal Reserve Bank (the "Fed") reduced the short-term interest rate by .5%. In addition, below are the 19 members' projections for rates at the end of 2024. The median rate forecast is 4.375%.



This implies another .5% of interest rate cuts by year-end.

As the short-term rates controlled by the Fed come down, this will benefit closed-end funds with leverage that invest in fixed rate bonds. This means we are likely to see higher income generated on the Long-Term Income portfolio as well as the California Municipal Bond portfolio.

Here are the committee's projections for the end of 2025:



The median forecast above, implies rates will be cut another 1% in 2025 to 3.375%. The tax-exempt portfolio will especially benefit because it was most effected by short term rates being higher than long term rates.

Long-term rates may also go down, but they could also just as easily go up - if lower short-term rates cause the market to price in higher inflation and faster economic growth. In the 12 days since the Fed made its first cut, this is what has happened – though the move has been small.

Longer term, the Fed's projections show that they expect to reduce short-term rates to below 3%. I think this will become a necessity as the nation's debt grows ever larger relative to the size of the economy. The current political environment favors stimulative fiscal policy and ever-increasing government debt. In my view the ultimate result must be higher inflation, but I cannot predict when market forces will react. It may still be many years before we reach the debt reckoning.

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