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Investment Newsletter – March 2025

Executive Summary

The Short Term Income portfolio returned 13.8% over the last year. I estimate that new tariff policies will reduce GDP growth by 2.3% and increase inflation by 2.4% this year. While these policies triggered a market decline, the adjustment appears sentiment-driven rather than rooted in economic fundamentals. Investors with appropriate long-term strategies can ignore this type of price volatility.

Short Term Income Portfolio Strategy and Performance

Berkeley Investment Advisors uses several strategy portfolios to manage client assets. The Short Term Income portfolio, which we focus on in this, its anniversary quarter, is a fixed income portfolio holding short to intermediate rate maturity loans and bonds. Typically shorter maturity bonds offer lower interest rates (yields) than longer maturity bonds (but not currently), and are less sensitive to changes in interest rates. This category includes securities with floating interest rates that can reset periodically depending on market conditions. For example the rate paid could be set based on banks' "prime rate" or the 3-month term Secured Overnight Financing Rate. These rates, in turn, change as the Federal Reserve Bank raises (or lowers) its "Fed Funds Rate".

The interest rate risk sensitivity of the portfolio is measured by its duration. Usually a short term bond fund strategy owns bonds with durations below 3. If we held a bond with duration of 3 when rates went up 1 percent, we would expect the bond's price to decline by 3 percent. The current duration of the portfolio is 1.3; one year ago it was 1.4.

There is also credit risk in our portfolio –borrowers may default and not pay all that is due. High yield bonds and loans have a higher probability of default than investment grade rated bonds, but they 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 fluctuations in the economy. We

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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. For a detailed explanation of the advantages of closed-end funds see the March 2017 newsletter. To hold these securities we must endure more price volatility in down markets: retail investors want to sell more at lows.

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.

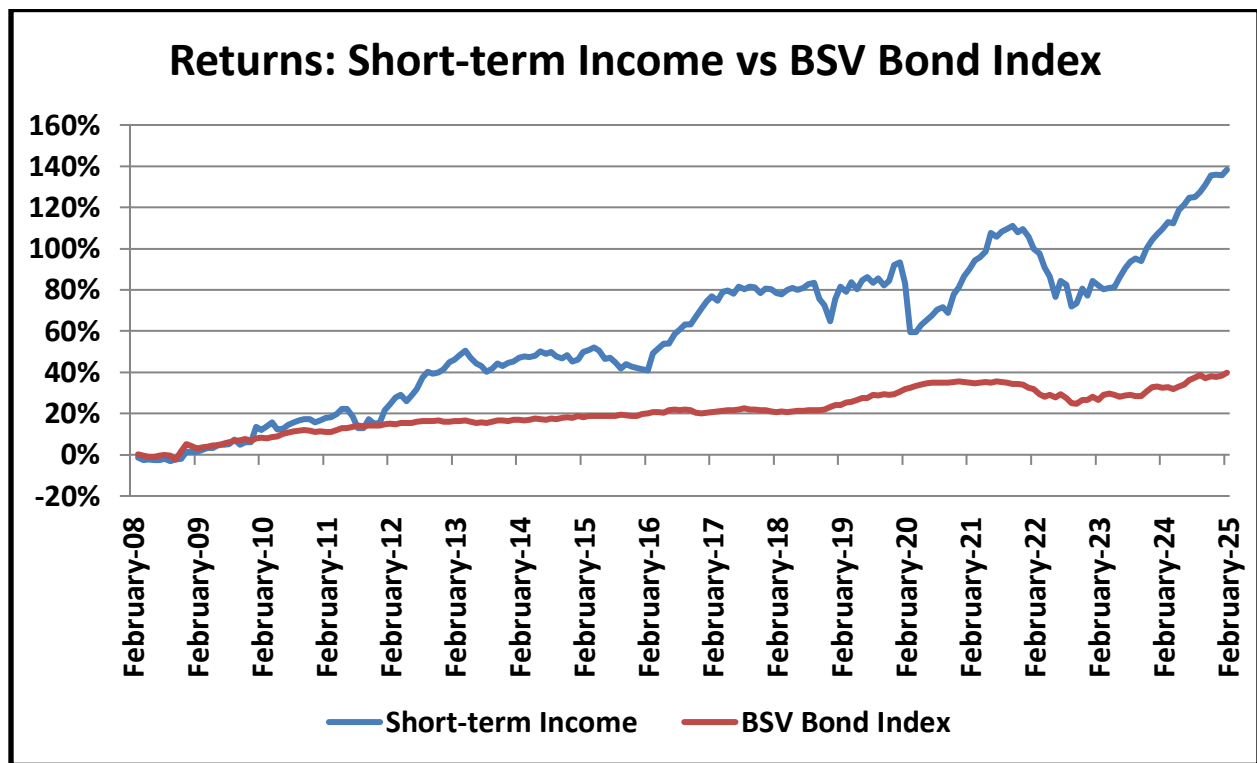
Some clients have had money invested in this portfolio since it was created in February 2008. The graph and the table on the next page show total returns including price and interest payments in comparison to the bond index mentioned above as implemented in the exchange traded fund (ticker BSV). Our portfolio returns calculated here are based on a particular client’s account and have been reduced by annual fees of 1.25 percent which would apply to new accounts above \$500,000 but below \$1 million.

The graph shows increasing volatility for the strategy’s returns since the Pandemic started. This strategy has had losses in 2 out of 17 years (and underperformed its benchmark in 6 years out of 17 years), but generally there is lower risk of principal loss over a year’s time than in other strategies - such as stocks or long term bonds.

The last 2 years have been bounce-back years. In 2022 the Federal Reserve raised rates so rapidly that the rate adjustments in our portfolio did not keep up. This, coupled with a more risk-averse environment, led to a surprising and counterintuitive loss that year. In contrast, the Fed slowed rate rises in 2023 and stopped raising rates after July. More stable rates combined with rising dividends led to good performance since 2022.

In addition, we took advantage of a rare opportunity in early 2023 which has paid off big over the last 2 years. A fund (ticker FSCO) that had previously been a private fund, went public. Existing shareholder who had not previously had liquidity, rushed to sell. This drove the discount beyond 30 percent in early 2023. The steep discount combined with very high dividends resulted in a 49 percent return on this position over the last 2 years. This is an astounding result for a short rate maturity credit investment and it was by far our largest position. This demonstrates the inefficiency in the closed-end fund market that enables us to earn returns in excess of the benchmark.

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The table below shows the portfolio returns by year since inception.

Returns by Year				
Year	Year Ended	Short term Income	BSV Bond Index	S.T. Income – Index Diff.
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%
11	2/28/2019	1.7%	2.9%	-1.1%
12	2/29/2020	0.9%	6.2%	-5.3%
13	2/28/2021	3.9%	2.3%	1.6%
14	2/28/2022	5.1%	-2.2%	7.3%
15	2/28/2023	-8.9%	-4.0%	-4.9%
16	2/28/2024	15.1%	4.5%	10.6%
17	2/28/2025	13.8%	5.6%	8.1%
Compounded Total		138.3%	39.8%	98.5%

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Over the last year, the strategy return was 13.8 percent, while the Vanguard Bond Index Fund earned 5.6 percent. The cumulative return for the strategy from 2/29/2008 to 2/28/2025 is 138.3 percent. Thus the annualized compounded rate of return since inception (17 years ago) has been 5.24 percent.

Over the year ended 2/28/25 credit spreads have declined by .42 percent. This should have increased the portfolio value by about 1.3%. In January spreads had reached the lowest level since 2007. By the end of February credit spreads were still at very low levels. They have since risen significantly - though they remain below average.

In addition overall closed-end fund discounts declined about 1.95 percent in the year ended February 28, 2025, while the Short Term Income discounts dropped about 5 percent. This was a significant contributing factor to the mark to market gains of this portfolio. Currently average closed end fund discount in the portfolio is 3.4 percent which is quite low.

Although the above valuation factors are unlikely to contribute to returns going forward, the portfolio's current dividend yield of 8.1 percent is still quite high.

Government Policy Scenario Update

In the December 2024 newsletter I analyzed a large number of policy scenarios and provided my estimates of the likelihood of each scenario and an estimate of economic and market impacts. Despite the seemingly daily announcements coming out of Washington, almost none of the uncertainty documented in December has been resolved. The exception is tariff policies.

The new administration has acted quickly to start implementing large tariff increases. There is still much uncertainty regarding what tariff policies will really be implemented, but there are some tariffs that have become certainties, or at least high probabilities:

- Tariffs on China were raised by 20 percent.
- Tariffs on all steel and aluminum imports were raised to 25 percent.
- Tariffs on Canada and Mexico are scheduled to rise 25 percent on April 2nd.
- Also a plan for reciprocal tariffs is to be announced April 2nd.

The tariffs now in effect are less impactful than any of my December scenarios but they will increase prices and inflation noticeably. They will also disrupt certain businesses.

The tariffs scheduled for April 2 were included in my analysis with probabilities of 10-20 percent. Even today, I put the probability of all these tariffs being in place at year end at no more than 70 percent. But we've gone from unlikely to very likely.

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I'll provide context and analysis for these new policies but first let's tackle what reciprocal tariff polices may mean in practice. At a superficial level this could mean simply that we take each nation's tariff schedule for U.S. goods and apply the rates for each category of U.S. goods (Cars, computers, wheat, etc.) to those same categories of goods exported to the U.S. Because the composition of goods exported is different from the composition of goods imported, we could still end up with low tariffs on most imports even while our trading partners have high tariffs on our exports.

A further complication to reaching the "fairness" goals of the president is that many nations have strong non-tariff barriers (NTBs) which limit our exports. For example, Japan has relatively low tariffs, but has put up other barriers to our Agricultural and Auto exports. Economists estimate the "tariff equivalents" for such protectionist policies. In the case of agricultural exports to Japan, the NTBs equate to Tariff Equivalent rates of between 30 and 60 percent. Across the whole range of potential exports to Japan, NTBs are estimated to be equivalent to 10 percent on average. Therefore if the government goes through the very complex exercise of trying to achieve some version of Tariff Equivalent fairness, it will be a huge amount of analysis with enough assumptions to derive almost any result.

Currently we can only guess at the magnitude of worldwide reciprocal tariffs. I'll continue to use my December estimate of 20 percent which is high for Japan but perhaps low for protectionist countries like India and Brazil. (As of today this is also a potential across the board tariff level).

Besides looking at direct impacts, we can also estimate the potential impact of trading partners' responses on our exports.

As a starting point, the table below shows U.S. imports and exports as a percentage of Gross Domestic Product for the tariff targets. Just below these contextual numbers are the likely tariffs on imports and some guesses on retaliation impacts on our exports.

Trading Partners:	China	Mexico	Canada	Other Countries	Total
2024 Imports as % of GDP	1.6%	1.9%	1.6%	8.9%	14.1%
2024 Exports as % of GDP	0.7%	1.3%	1.5%	7.4%	10.9%
Proposed/Estimated Tariffs	20%	25%	25%	20%	
Retaliation Effect on Exports	20%	10%	10%	10%	

If all of these tariffs take effect and stay in effect, the direct impact on inflation would be about 3.0 percent for the year. I expect the direct impact on GDP growth of the decline in exports due to foreign retaliation to be a drop of 1.2 percent. I expect a similar drop from indirect effects because of disruptions of business supply chains. In total, GDP should come in roughly 2.3 percent lower than it otherwise would have. For context, we had 2.8

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percent growth in both 2023 and 2024 so these policies may, or may not, tip us into recession (depending on the actual implementation).

The decline in GDP growth will also have an indirect effect on inflation. I expect this to cut the inflation increase back to 2.4 percent. All of these are rough estimates and many other variables come into play in a complex economy like the U.S.

Many economists are making similar forecasts, so it may seem surprising the president would go down this path. The head of economic-policy studies at the American Enterprise Institute put it this way: “The president is a true mercantilist and just isn’t going to believe forecasts about how bad this can get; he needs to put his hand to the hot stove and leave it there until he can’t bear it”. My guess is: he’ll pull back if and when the forecasts come true.

Market Dynamics: Fundamentals and Sentiment

There are two major sources of changes in the market prices of securities which are important to understand:

1. Fundamental factors such company reports and economic data influence prices through changes in (price sensitive investors’) estimates of future cash flows.
2. Trader and investor sentiment (meaning attitudes towards risk) influence prices via emotions that cause either sellers or buyers to be more anxious to transact (which determines the direction of price changes).

Fundamental factors change slowly; it is changes in investor attitudes towards risk which drive most price movements. When risk-loving sentiment is prevalent, buyers bid up prices as sellers are reluctant to sell. This is called a Risk-On environment. When risk-averse sentiment takes over, anxious sellers must offer lower prices to coax reluctant buyers to trade cash for shares. This is a Risk-Off market.

When sentiment is strong/extreme, market participants can drive market prices far beyond any rational estimate of investment value – both to the upside and to the downside. We’ve witnessed the risk-on version of this in the 1999 dot-com bubble, in the 2021 spike in SPACs (special purpose acquisition companies), and in the 2023-2024 move.

Over the last 25 years more money has switched from active management (price-sensitive, based on fundamentals) to passive index funds, which are insensitive to prices relative to estimates of fundamental values. As a result, market prices can move even further away from what value investors like Warren Buffett call “intrinsic value”.

At the high point this year, valuations relative to fundamentals were higher than any time in history, including the dot-com bubble. In such a

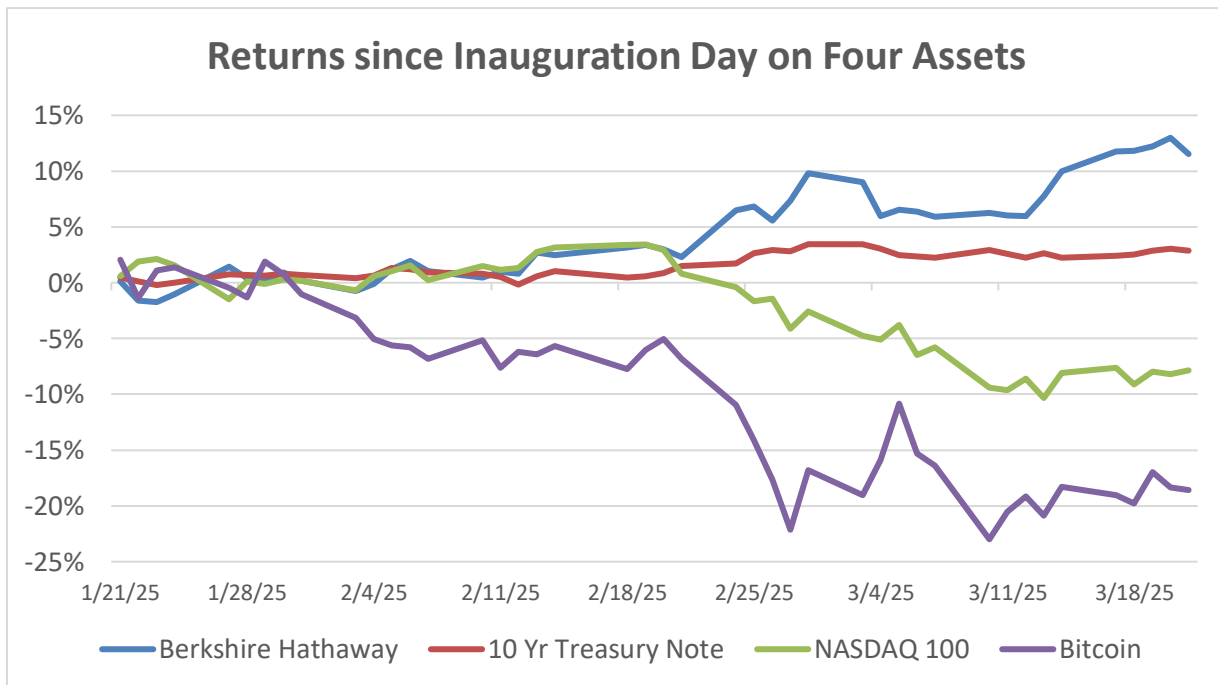
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market, investments that have a speculative component (that might pay off big far in the future) lead the market. In other words, as I mentioned in the December newsletter, higher risk wins.

As investors it is important to understand what is moving the market and also your own strategy for dealing with the emotional roller-coaster of the market. As a fiduciary for client money, I feel it is inappropriate to recommend speculative bets. To win at that game in the long run requires a large amount of luck. (Or you must find a way to predict trader's mood swings with extreme accuracy). I don't think retirement spending should depend on luck or clairvoyance.

Tariffs: The Risk-Off Sentiment Flip

The tariff policy changes discussed earlier constitute a significant shock to the economy. This raises the question: does the drop in the stock market indicate a large change in the fundamentals underlying the stock market or is it primarily a change in investor sentiment. A recent article in Morningstar provided an insightful analysis. They highlighted the performance of four assets to try to separate fundamentals and sentiment. My version of the chart, starting at inauguration day is below.



The four assets ranked from least uncertainty about future fundamental value to most uncertain future fundamental value are:

1. Ten year maturity Treasury Notes
2. Berkshire Hathaway stock (Warren Buffett's company)
3. NASDAQ 100 stock index
4. Bitcoin

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Both Berkshire Hathaway stock and the NASDAQ 100 stock index are sensitive to the economy. If the market were reacting to an expected recession we should see both going down – though the NASDAQ 100 would drop more. During the 2008 recession the NASDAQ 100 dropped 42 percent while Berkshire Hathaway dropped 32 percent. Today they are going in opposite directions which tells us it is not a recession forecast that is driving down the technology stocks.

Both the 10 year Treasury Notes and Bitcoin are insensitive to the economy. A recession has no impact on the government paying its bills and Bitcoin will never pay out cash, so cannot be impacted by a bad economy. The economic impact of tariffs cannot be driving Bitcoin down.

Looking at these four together we see that the winners were those assets that provide certain earnings now and the losers are the speculative assets with distant earnings (NASDAQ)¹ or no earnings ever (Bitcoin). Tariffs are therefore not changing fundamental values because of exposure to economic changes, but rather triggering a flight from speculative assets to safety, meaning sentiment has suddenly flipped to “Risk-Off” mode.

As Expected, Our Strategies are Holding Value

In the last two years the S&P 500 stock index has been driven largely by the more speculative technology stocks in the NASDAQ index. As explained above, we are now seeing this reverse as investors run from risk. The S&P 500 exchange traded fund (ticker SPY) lost 4.6% so far this year, while the NASDAQ index is down 10.4%. Because we avoid speculative equities, our strategies did not keep up during the speculative run-up, but we also did not accumulate speculative gains to be lost in the down part of the sentiment cycle. Here are our year-to-date returns for our equity strategies along with one fixed income strategy for comparison²:

Model Returns for 1st Quarter 2025

Strategy	YTD Return
International Equity	6.58%
Real Estate Inflation Protection	1.19%
Defensive Equity	4.94%
Long Term Income	3.03%

Conclusion

Currently securities prices do not reflect recession expectations. Credit spreads have increased but not enough to predict a recession.

¹ Technology companies are very profitable but very expensive. Current earnings relative to stock prices are typically very low. Thus, investors are paying for larger earnings expected to materialize in the distant future.

² These are our model returns from Goldman Sachs and do not include deductions for fees.

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Likewise, long term treasury yields have not moved down decisively as we might expect in a downturn. As long-term investors, who are not relying on luck or clairvoyance; consequently we should not be too concerned about the fate of speculative assets driven up and down by market mood swings. If you've invested in-line with the risks you're comfortable with, you need not do anything in reaction to the normal swings we observe in market sentiment.

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