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Investment Newsletter – June 2025

Executive Summary

Tariff related market volatility subsided too quickly to provide many bargains, but I expect future opportunities.

Big investment firms continually capitalize on investment fads by selling new products to appeal to investors' emotions. I show the dismal results for investors of recent fads and analyze the latest private fund fad.

I end with a case study explaining how we earned a 97% return thanks to desperate sellers exiting such a private fund when it went public.

Few Bargains Despite the Volatility YTD

As I explained in an April 5th email to clients, the reciprocal tariffs announcement of April 2nd surprised market participants and led to panic selling in early April. Large price drops increased some closed-end fund discounts dramatically and increased credit spreads[1] that compensate investors for holding credit-risk-sensitive bonds. Unfortunately, most of the best bargains were funds we already owned; prices did not drop far enough to give us the bargains that I hoped. I only did two purchases for the Long-Term Income fund, but these were not cheap enough for larger purchases.

On the equity side I adjusted the Defensive Equity holdings to reduce exposure to potential pharmaceutical tariffs.

Since early April the overall market has recovered its losses and again sits on the more expensive side of history. The consensus seems to be there are no further risks from tariff actions. I continue to hold some lower risk positions for the time when the market moves to a more fearful mode.

Investment Fads May be Hazardous to your Wealth

Financial market players are always on the lookout for the next great investment story to turn into a product fad so as to make money from the

[1] A credit spread is the interest yield on a security which is in excess of the rate you could get by investing in a government security of equivalent maturity.

popularity of the latest theme. These fads typically have a promise (a hook) that lures investors with an appeal to their emotions. It may be greed, fear, or both, or maybe it’s a desire to use investment to have a social impact. This could be as simple as having something to brag about at a cocktail party. In this article I’ll delve into a few fads by looking at the promise, and then the detailed reality, along with the performance and risks of each fad. I’ll cover SPACs, Exchange Trade Funds (ETFs) based on themes, ETFs using option strategies, private equity, private credit, and private real estate.

<u>Special Purpose Acquisition Corporations</u>

First up on my list is the class of equity securities know as special purpose acquisition corporations, know as SPACs for short. These have always been around but became hugely popular during the delusional speculation of 2021. A SPAC is a corporation with no operations and no initial assets that is taken public by a sponsor famous enough to generate buying interest. The hook used to lure investors is the idea that the cash put in by investors (almost always $10 per share) will enable this brilliant sponsor to purchase a real company (that wants to go public) at a good enough price that the SPAC investors can sell out at a profit.

These securities were structured to provide great returns to the celebrity sponsors. In addition, the initial public offering investors (IPO) who actually put cash into the SPAC had an option to get their money back when a merger was announced. Meanwhile investors in the public market, bought such shares at far above $10 at the height of the fad.

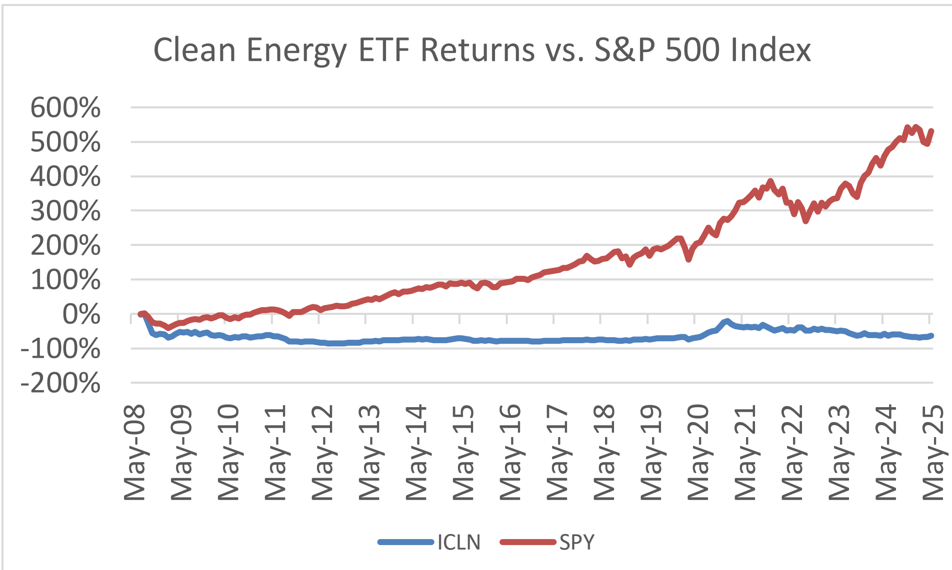
Because most SPAC terms are designed to enrich sponsors and IPO investors at the expense of public market investors, the median returns for public investors were horrible. For example, according to the research paper “Was the SPAC Crash Predictable”, as of 12/1/22, SPACs that merged between July 2020 and December 2021 had an average share price of $3.85, a loss of over 60% even if you only paid the original $10 share value. The public eventually caught on to these poor returns and so, with no more suckers to fleece with SPACs, sponsors moved on to other ideas.

<u>Theme ETFs</u>

Although SPACs might be the worst performing fad product in recent times, “theme” ETFs are worth examining. My example is the iShares Global Clean Energy ETF (ticker ICLN), which seeks to track an index of global equities in the clean energy sector. When launched in 2008, the pitch from the sponsor was: “Do well by doing good — invest in the global clean-energy revolution.” By promising that investors could *align their money with their ideals* while tapping a fast-growing sector, the “do-well-by-doing-good” message gave ICLN an immediate emotional punch that helped it stand out among niche ETFs launched during the 2008 alternative-energy boom.

While investments in clean energy can provide long term benefits to society, the underlying companies have not produced financial returns. There are two factors typically working against a theme ETF. First, prices of the underlying companies have already been bid up to unreasonable levels prior to the fad attracting the ETF sponsor's attention. Second, concentrated theme portfolios are riskier than diversified portfolios and are often composed of companies with low or no profitability.

Here is a comparison of the Global Clean Energy ETF returns to those of the S&P 500 index ETF using ticker SPY.



Since inception this ETF has **lost 64%** of its value while the S&P 500 gained 531%. The table below shows annualized returns over three lookback periods ended 5/31/2025:

	Annual Returns	
Period	**ICLN**	**SPY**
Since Inception	-6.0%	11.6%
Last 5 years	2.3%	12.8%
Last 10 years	2.4%	15.8%

This fund had very bad timing, launching in June 2008. But even ignoring the financial crisis, it has had poor returns. Although the appeal of this fund was never about earning returns, investors should recognize the potentially large opportunity costs of investing in popular themes.

Option ETFs

There are several types of Equity Option[2] ETFs using different hooks for investors. Morningstar has three categories:

1. Derivative Income – usually selling covered stock index call options[3].
2. Defined Outcome – buys put options to protect downside while selling calls which limits upside.
3. Options Trading – Equity Hedged – funds using options but not in categories #1 and #2.

The hooks for investors are the promise that options strategies reduce risks while still allowing them to participate in stock market returns. Defined Outcome ETFs are often called Buffered ETFs in marketing pitches because they "buffer" the downside risk (and upside gain). This category is extremely popular right now. In May an excellent analysis was published by AQR which I will summarize here.

For their analysis they compare each ETF to a portfolio of stocks and cash such that market risk exposure (Beta[4]) is equalized. This benchmarking allows them to see if the funds are adding any value that could not be matched by a simple risk allocation choice. For an ETF to add value relative to a simple allocation, it must produce either higher returns for the same or lower risk, or it must have lower risk with an acceptable cost in lower returns. AQR looked at all these ETFs that existed from 1/1/2015 to 4/30/2025. The table below summarizes the percentage of funds that fell into each of the four quadrants as defined by lower and higher returns across the columns and lower and higher drawdown risk across the rows.

		Cumulative Return Compared to Stocks+Cash	
		Worse	Better
Drawdown Compared to Stocks+Cash	Better	6%	0%
	Worse	84%	10%

[2] A call option contract gives the owner the right to buy a stock or index ETF at a fixed price from the seller of the option. A put option contract gives the owner the right to sell a stock or index ETF at a fixed price to the seller of the option.

[3] A covered call means that you own the asset and you are selling the right to buy that asset at a fixed price for a specified time.

[4] Beta measures the ratio of an asset's movements to those of the market – on average. A Beta of 1 means it moves in line with the market. A Beta of .5 means it moves half as much.

The upper right square shows that none of the funds had both higher returns and lower drawdown risk. The lower left square shows that 84% of these funds had both lower returns and higher risks – the opposite of adding value for investors. The lower right box showing 10% indicates ETFs with higher risk but higher returns – inconsistent with the pitch they are making to investors. For the 6% in the upper left box, they are lowering risk at some cost to returns. In this case we want to know the tradeoff.

AQR did not answer this question for the 10-year period. Instead, they looked at a larger set of funds that have existed since 1/1/2020. For this shorter period, they found that funds in this category had a .7% advantage in maximum drawdown versus the benchmark allocation, but the cost was a 7.3% reduction in cumulative returns. This is not a good trade off.

There are fundamental reasons why these strategies do not deliver on their marketing pitches. Options are costly to buy. They expire and you have to repurchase new ones. The downside protection offered is weaker than simply reducing equity exposure directly. Because of these disadvantages, the longer you hold these ETFs the worse you're likely to do compared to your alternative.

AQR asks "How can there be demand for something that overwhelmingly underperforms both in risk and return". The answer is in the marketing hook – people believe they can get an edge via an ETF product. AQR points out that this may have a placebo effect for investors: there is psychologically generated benefit. In medical trials some patents are given a sugar pill as a placebo to control for the effect that just getting a pill may cause patients to report help with symptoms. Given the danger of investors selling in panic during a market decline, a Buffered ETF may be the placebo that prevents capital-destructive selling at a low – even though it offers little actual protection relative to a proper risk allocation.

<u>Private Equity and Private Credit</u>

Recently there has been a lot of buzz about retail investors getting the chance to invest in funds of private assets, previously sold only to accredited investors. Private equity and private credit assets have historically required higher returns (a risk premium) to compensate for their lack of liquidity. To understand the cost of this lack of liquidity for investors, consider the example of Starwood Real Estate Income Trust (SREIT).

As interest rates began to rise sharply in 2022, investors started seeking to withdraw capital from SREIT, leading to a surge in redemption requests. By Q4 2022, redemption requests reached 6.7% of stockholder net asset value (NAV[5]), exceeding the then-current quarterly capacity limit of 5% and leading to proration (partial fulfillment) of requests.

[5] Net asset value refers to the assets of a fund after subtracting its liabilities – the amount owned by shareholders.

Redemption requests consistently exceeded the fund's limits and in May 2024 SREIT reduced the redemption amount allowed to 1% of NAV per quarter. As of this month the limit has been raised to 1.5% of NAV quarterly, but the backlog of investor requests for their cash remains high at $850 million. Over this period the NAV officially dropped 24%.

Investors in these assets were institutions or other accredited investors[6] who could afford to wait many years to get their money back so long as they could earn a premium return compared to similar publicly traded assets (meaning the liquidity risk premium). To earn higher returns requires that the assets be valued lower than their public counterparts. The private fund industry now thinks they can arbitrage this difference in valuation and capture more for themselves by selling these assets in a publicly traded fund wrapper to retail investors. The marketing hook is: you will finally get to buy into this previously forbidden asset class so you can now also earn the same premiums as the most sophisticated investors.

But the liquidity mismatch may be problematic depending on the fund wrapper. Mutual funds are inferior vehicles to closed-end funds for holding illiquid assets. Because a mutual fund must redeem fund shares at NAV and sell assets to pay the shareholder, such funds are likely to suffer large capital losses in a panic selling environment as they sell assets at whatever price they can get to meet redemptions. ETFs are better in that they are not forced to redeem shares for cash. But in practice, an ETF holding illiquid assets will behave more like a closed-end fund than an ETF. By that I mean they will trade at significant discounts or premiums to the underlying assets. Many unsophisticated investors will be surprised to learn that the NAV is meaningless when they want to sell to raise cash.

As of May 19th 2025, the Securities Exchange Commission dropped a rule limiting closed-end funds to holding no more than 15% of assets in private funds. I think this is the natural way for investors to invest in private credit. Indeed, we already have closed-end fund investments that are heavily concentrated in non-public credit assets that they own directly rather than indirectly via private funds. On the equity side, publicly traded Business Development Corporations (BDCs) (which are effectively closed-end funds for investments in private equity and credit) have long been the way for investors to get exposure to private equity investments. So, the thing that is new here is that the private fund sponsors are trying to access public market investors via fund structures that allow unlimited sales. Traditional closed-end funds and BDCs are not structured to facilitate inflows and outflows of investor funds. Such funds can sell new shares but generally are precluded from doing this when share prices are below net asset value (which is very common).

[6] This is a category of individuals defined by the SEC as sophisticated enough to understand the risks.

Sponsors are likely to tout their products as a way to invest in a historically higher return asset class as their hook for investors. They may also argue that these assets have lower risk because private funds do not report actual market values. Investors need to keep in mind that they cannot fundamentally change the nature of the underlying illiquid assets. In times of market stress funds holding illiquid assets will be more volatile. Investors should look carefully before paying the sponsor's asking price (NAV) for assets that would likely trade at lower prices in the private market.

Conclusion

Beware of fad investments – those that have high fees, buzzy stories, and appeal to investor emotions. Long-term returns are often insufficient for the risks embedded in these new products. Following the crowd may be profitable in the short run but typically results in sub-par long-term returns.

My job is to help you avoid falling for marketing pitches so as to focus on actual risk and return with a strategy to meet your goals. And, when possible, profit from the emotional follies of other investors – the old-fashioned way: buying assets cheap when the excitement wears off.

A Private Fund Goes Public, A Case Study

This case illustrates how private funds raise money from investors, how investors get their money back, and what happens when such a fund becomes publicly tradeable. It also illustrates how clients of Berkeley Investment Advisors profited from the conversion of the FS Credit Opportunities (ticker FSCO) fund from private to public.

This fund, originally named FS Global Credit Opportunities Fund, was set up in 2013 and listed its shares on the exchange in November 2022. Prior to the public listing, the fund sold shares to accredited investors through brokers. These brokers earned commissions ranging from 2% to 8% up front. (Lower upfront commissions generally are used when ongoing fees are higher). Thus, these commission-based advisors have an incentive to distribute new shares to their clients regardless of whether it is in the clients' interest. On average you should expect investments that involve large commissions to perform worse than investments not requiring such incentives to sell. Because most fund assets have no market price, the net asset value of the fund does not move with the market. I.e. the sponsor does not report true market values. Therefore, brokers can claim that these are low risk shares because shareholders cannot see movement in value.

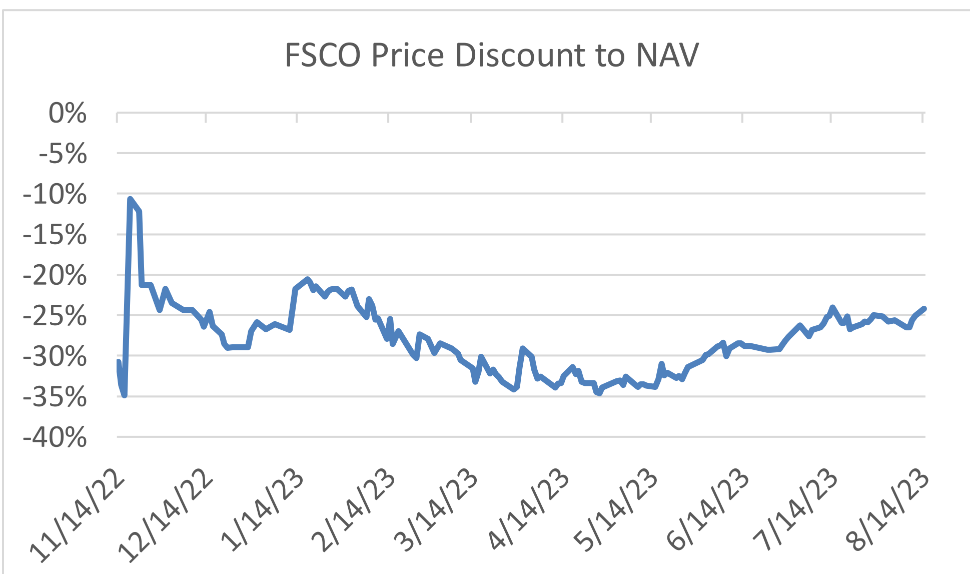
The only way for these investors to sell shares was through the fund's quarterly repurchase program[7]. These repurchases were limited to the lesser

[7] Funds that have this structure are called "interval funds". You can get some money out at each interval.

of dividends reinvested by the shareholders in fund shares or 5% of weighted average outstanding shares. Although we cannot find pubic disclosure, it is very likely that redemption requests vastly exceeded the quarterly amounts repurchased. Since repurchases effectively reduced the amount of future repurchases (the 5% limit), there was no possible way for everyone to get their money back. It is likely that complaints from the investors and brokers caused the sponsor to list the shares so as to mitigate reputational risks.

Because it was clear that many investors wanted out and would sell as soon as possible at almost any price, the fund did a three-phase public listing by allowing shareholders to sell a third of their shares at the initial listing date, then another third of their shares 90 days later and the final shares 180 days later. The goal of spreading out existing investor sales into three tranches was to try to limit the discount to net asset value at which selling shareholders would be selling.

In such a situation there is no marketing to drive demand for the shares. Therefore, the larger the supply of shares to be sold at any one time, the lower the price must be to induce the limited buyers to provide liquidity to sellers (by buying sellers' shares). Spreading out the sales gives time for additional buyers to learn about the shares and therefore sales prices should not need to drop as far. Here is a chart of the price discount to net asset value for the 9 months after the initial listing.

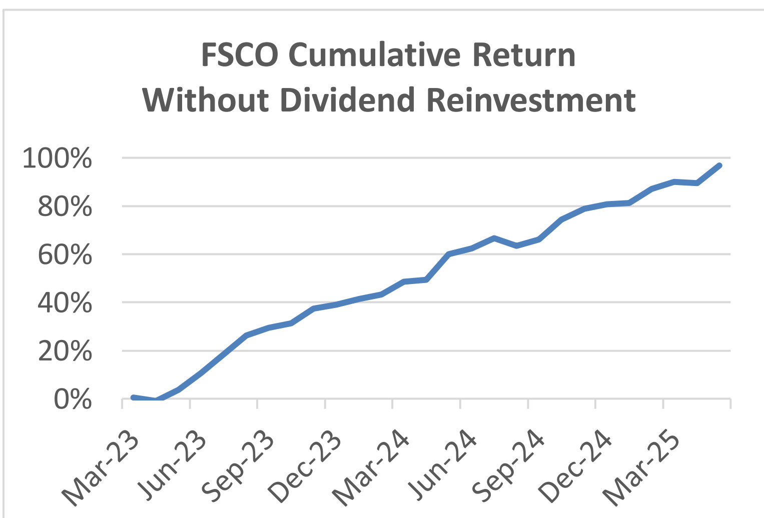


On the first trading day, investors had to take a 31% discount to unload their shares and get their money that had been locked in the fund. The lower discount shown for a couple of days in November 2022 is likely incorrectly reported prices. The second wave of selling started 2/13/23 and the third round of locked-in investor selling started on 5/15/23.

You can see a 7% spike up in price that occurred 1/13/23 because an article appeared on SeekingAlpha about this fund. I read this article and did some research on the fund before starting to buy on 1/18/23. At the time it looked as though this publicity might generate enough demand to absorb the sales from the legacy investors. But the second wave of selling pushed the discount back to lower levels. This provided me an opportunity to add to the position. This market action did however deter buyers from pushing up the price in advance of the known date of the 3rd lockup expiration. As you can see, the discount started steadily shrinking after this 3rd selling wave.

In the long run the public price will reflect true underlying economics – net interest income and payouts to fund holders. When we did our first purchase, the price gave us an annual yield of 11.5%. When we stopped the initial round of accumulation, our weighted average yield was 12.6%. Over time, more investors see the value and buy. The original owners/suckers eventually are all out and prices are set by slightly more informed investors so the discount melts away. Currently FSCO still offers a yield of 11.2% and trades at a .5% discount to net asset value. This is the largest position in the Short-Term Income portfolio.

The chart below shows our cumulative return without dividend reinvestment, starting from the end of our first round[8] of buying at 3/9/23. Through 5/31/25 we earned 97% on this position. If we assumed dividends were reinvested, the compounded return would be 111%. Because this chart uses monthly data, it does not show the huge drop that happened the first week of April. If you had bought FSCO on April 7th and held till the end of May, you would have gotten a 26% return on your investment.



[8] We also did additional buying during September to October 2023, and again in March and June 2024. A small portion was sold in January 2025 to reduce our concentration in this security which resulted from the big gains.

Long time readers may recognize this story of profiting from overly anxious investors as similar to another large CEF discount-closing back in 2016: Brookfield Total Return Fund. In that case a famous bond fund manager named it as a best idea in a Barron's article 1/23/16 - when it was the largest holding of Short-Term Income and trading at a discount of 14.4%. Before the end of that March, it was trading at a premium to net asset value. We sold in that case to desperate buyers.

Conclusion

The lesson of FS Credit Opportunities fund is to beware of illiquid assets sold by commissioned brokers, but be ready to provide liquidity to desperate sellers when they are ready to sell at a large discount to true value. This is one of the ways Berkeley Investment Advisors enhances client returns relative to typical fixed income benchmarks. We get paid well for providing liquidity in the relatively low liquidity world of closed-end funds.

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