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Investment Newsletter – September 2025

Executive Summary

Opportunity costs should be considered for every big financial decision in life: we must examine if a potential use of savings is optimal when considering alternative uses. Mortgage prepayments and rental home purchases illustrate the trade-offs to consider.

A relatively stable interest rate environment yielded a good return in the Long-Term Income strategy but a surprisingly poor return for the Real Estate portfolio. On the positive side, this likely means better returns lie ahead.

Making Smarter Financial Decisions: Understanding Opportunity Cost

Have you ever wondered if paying off your mortgage early is really the smart financial move it seems? Or whether that rental property investment makes sense? The answer depends on understanding a critical concept: *opportunity cost*.

What Is Opportunity Cost?

The real cost of any financial decision isn't just the dollars you spend. It's what you give up by not using that money differently. When you put \$50,000 toward paying down your mortgage, you're not just reducing debt—you're also choosing not to invest that \$50,000 elsewhere. The return you could have earned on that alternative investment is your opportunity cost. Think of it this way: every dollar can only be used once. Choosing one path means closing the door on another.

Should You Pay Down Your Mortgage Early?

This is one of the most common questions we hear, and the answer surprises many people.

What You're Really Buying

When you make extra mortgage payments, you're essentially buying a long-term investment that:

- Locks in your mortgage interest rate as your return
- Cannot be accessed until you sell your home or refinance

- Loses value if inflation rises (because you've locked in today's dollars)
It's like purchasing a certificate of deposit that you can never cash in early, earning whatever your mortgage rate is.

The Hidden Costs

Loss of Flexibility

Once you prepay your mortgage, that money is locked in your home equity. You can't access it without selling, refinancing, or taking out a home equity loan. If your investment portfolio drops and you need cash, you may be forced to sell investments at exactly the wrong time.

Inflation Risk

Long-term bonds (which is what a mortgage prepayment resembles) lose value when inflation rises. If you keep money liquid instead, you can shift to investments that keep pace with inflation when rates rise.

Missed Investment Opportunities

Warren Buffett has made billions by keeping cash available to buy assets when others are panicking. While most of us aren't Buffett, having liquidity lets you take advantage of market downturns—buying stocks, funds, or real estate at bargain prices.

When Does Prepaying Make Sense?

Consider prepaying your mortgage only when ALL of these conditions are true:

- Your mortgage rate is higher than your long-term investment returns
- You have zero chance of needing that money for at least the mortgage term
- You're comfortable with inflation risk eating into your locked-in return
- You've already maximized all tax-advantaged investment accounts

Even then, it might not be optimal if there's a reasonable chance that inflation or interest rates could rise substantially.

Bottom Line on Mortgage Prepayment

If your mortgage rate is 3.75% and your alternative investments typically earn 5.25%, prepaying costs you roughly 1.5% annually in lost growth—plus you lose all flexibility. For most people in most market conditions, this isn't the optimal choice.

Will Buying a Rental House or Condo Increase my Wealth?

Rental properties can be emotionally appealing, especially if you're considering short-term rentals or vacation properties you might use personally. But we know the security and tangible nature of real estate matters beyond just dollars. Let's look at what that emotional satisfaction actually costs financially.

Key Assumptions for Today's Market Environment

I've created a simplified analysis to help you evaluate rental property decisions. I'll assume the property is held for 10 years for these calculations and that your alternative investments would earn 5.25%. Also, I will ignore income taxes as that would be specific to the investor.

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We will use the following estimates for a typical investment in California or other similarly expensive states:

- Property price: \$800,000
- Down payment: 20% (\$160,000)
- Closing costs: 2% (\$16,000)
- Total initial investment: \$176,000
- Mortgage rate: 6.5%
- Annual appreciation: 3% (matching inflation)
- Selling costs at year 10: 6% of sale price

Scenario 1: Paying 16 Times Annual Rent (Borderline Acceptable)

If the \$800,000 property rents for \$50,000 per year (\$4,167/month), you're paying 16 times the annual gross rent. Once we take into account costs such as property tax, insurance, repairs, maintenance, and other operating costs, we get:

- First year net income after operating costs (before mortgage): \$30,000
- First year cash flow (after mortgage): -\$18,543
- You'll have negative cash flow every year until sale
- After 10 years when you sell: Net proceeds of \$468,058
- Compounded annual return: 5.12%

If your alternative investments would earn 5.25%, this investment almost breaks even after accounting for opportunity cost. At this price point, personal use or tax benefits might justify the purchase—but financially, it's marginal at best.

Scenario 2: Paying 18 Times Annual Rent (Poor Investment)

If the same \$800,000 property only rents for \$44,444 per year (\$3,704/month), you're paying 18 times the annual gross rent. In this case we calculate:

- First year net income (before mortgage): \$24,778
- First year cash flow (after mortgage): -\$23,765
- Larger negative cash flows every year until sale
- After 10 years when you sell: Net proceeds of \$468,058
- Compounded annual return: 3.12%

By paying just 2x more relative to rent, your return drops from 5.12% to 3.12%—a massive 2% difference. Compared to your 5.25% opportunity cost, you'd be losing over 2% per year for a decade. You'd barely keep pace with inflation.

Quick Comparison

Purchase Price Multiple	Annual Return	Gap vs. 5.25% Alternative
16x annual rent	5.12%	Nearly breaks even
18x annual rent	3.12%	Lose 2.13% annually

The Rental Property Decision Framework

Before buying a rental property, ask yourself:

- Can I buy it for less than 16 times annual gross rent?
- Will I need this capital within 10 years?
- Am I prepared for years of negative cash flow?

- Do tax benefits or personal use add significant value?
- Am I giving up higher returns elsewhere?

Bottom Line on Rental Properties

In today's market, only consider rental properties if you can purchase them for less than 16 times annual gross rent. At 18x rent or higher, the financial returns typically don't justify tying up your capital—unless non-financial factors (personal use, location desirability, etc.) add substantial value.

Making Better Financial Decisions

Understanding opportunity cost helps you avoid investments that quietly drain your wealth. Every major financial decision should include this question: What else could I do with this money?

Of course, not every decision is purely financial. Peace of mind, personal enjoyment, and family considerations all matter. The key is understanding the true cost of your choices—both the dollars you spend and the returns you're giving up.

Before making your next major financial decision, let's run the numbers together. We can help you quantify both the direct costs and the opportunity costs, so you can make the choice that's truly right for your situation.

Note: This analysis uses simplified assumptions for illustration. Your specific situation may involve different tax implications, market conditions, and personal factors. Individual analysis is recommended for all major financial decisions.

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. 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 4.7 (it was 4.8 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.

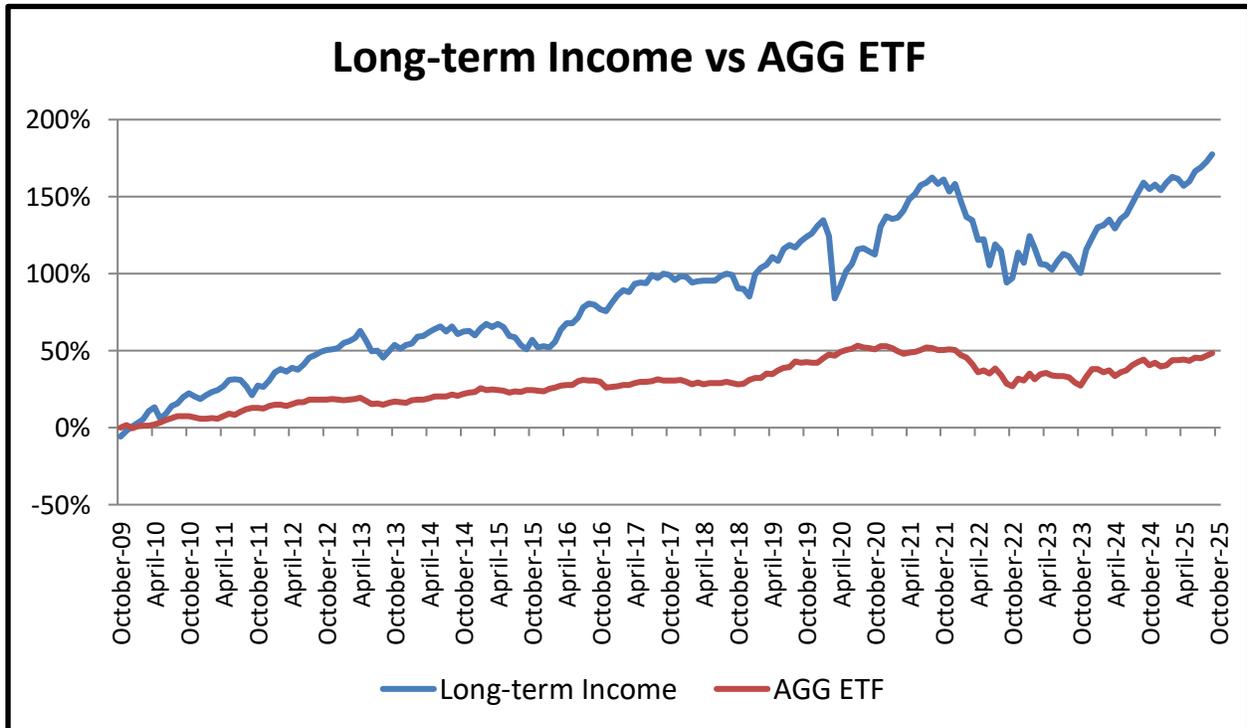
The extra return on high yield bonds over the interest rate paid by the U.S. treasury is called a credit spread – it is the compensation that investors demand for taking credit risks. These spreads change according to investors' risk preferences – i.e., how much they need to get paid for taking credit 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

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portfolio return was **7.1%** compared to **2.9%** for its bond index benchmark (AGG). The total return over sixteen years was 177.5% - an annualized compound rate of return of 6.6%.

The Long-Term Income portfolio experienced extremely high volatility in the 3 years prior to this one as interest rates moved very fast and erratically due to the uncertainties around the path of inflation and Federal Reserve interest rate policies. With the exception of the April tariffs announcement, the policy environment has been more stable over the past year.

Returns by Year

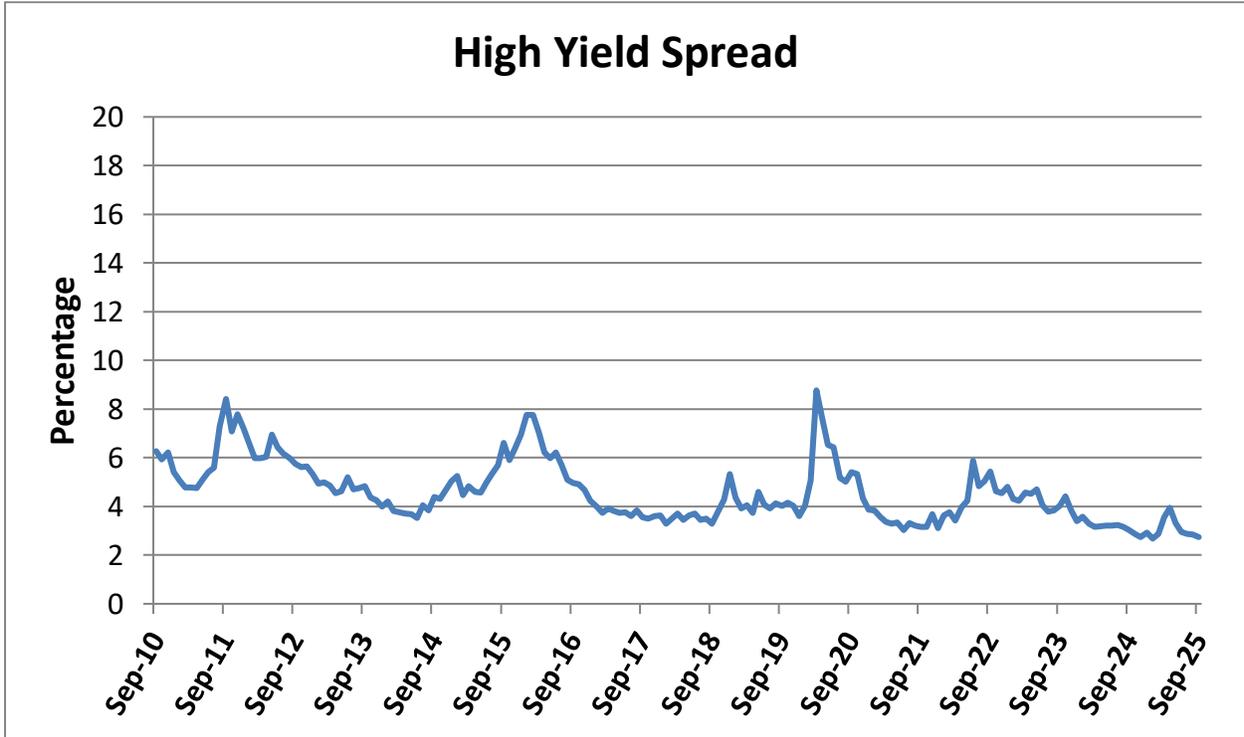
Year	Year Ended	Long-Term Income	AGG Bond Index	Difference
1	9/30/2010	19.8%	7.4%	12.4%
2	9/30/2011	1.2%	5.0%	-3.8%
3	9/30/2012	23.1%	5.0%	18.1%
4	9/30/2013	0.2%	-2.0%	2.3%
5	9/30/2014	7.6%	4.1%	3.5%
6	9/30/2015	-6.4%	2.9%	-9.3%
7	9/30/2016	19.4%	5.2%	14.2%
8	9/30/2017	11.3%	-0.1%	11.4%
9	9/30/2018	-0.5%	-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%	5.2%
15	9/30/2024	26.3%	11.6%	14.7%
16	9/30/2025	7.1%	2.9%	4.2%
Compounded Total		177.5%	48.5%	129.0%

For the year ended 9/30/2025 the interest rate on 10-year treasury bonds increased from 3.79% to 4.15%. I estimate that this interest rate increase decreased the market value of the portfolio by around 1.7% compared to last year (3.8 average duration times the .36% interest rate increase). Remember our portfolio value moves in the opposite direction of interest rates.

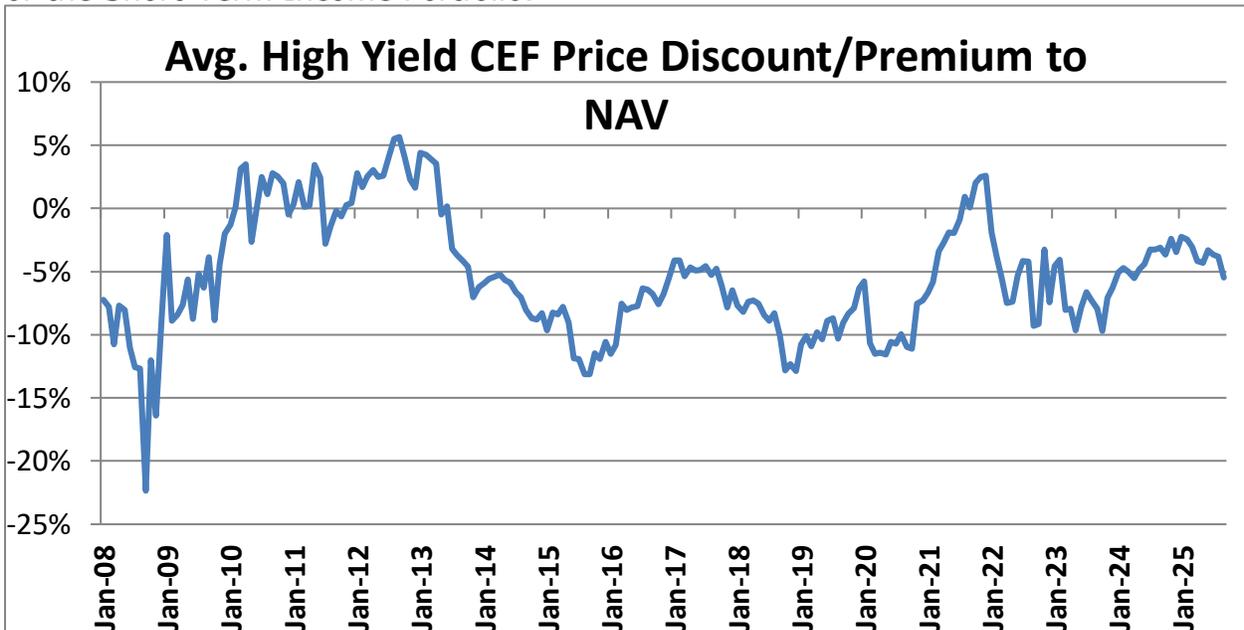
The graph on the top of the next page shows credit spreads over the last 16 years. The median spread over this period is about 4.3% and spreads gyrate around this central tendency, driven by market sentiment. The current spread of 2.74% is .29% lower than last year. I estimate that the decrease in credit spreads contributed approximately 1.1% to the increase of the portfolio over the last year – partially offsetting the interest rate increase.

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 2nd graph on the next page. 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 5.5%. Two of these funds are currently in the Long-Term Income portfolio. The actual average discount in the portfolio dropped from 3.9% last year to 2.3% this year.

As of 9/30/25, the underlying yield on the funds in the Long-Term Income Portfolio is 6.74% (before fees). From these levels, the portfolio offers acceptable expected returns for this market environment.

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 is allocated 54% to residential REITs, 28% to self-storage REITs, and the remainder invested opportunistically in other real estate securities and gold.

Currently this portfolio provides a dividend yield of 4.66% 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. 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. The decline in rents has dampened dividend growth and investors have responded by bidding down REIT prices to compensate for lower growth. Consequently, over the last year, the portfolio lost 13.1%, during a huge up market for stocks.

These returns are very disappointing, especially because we see the S&P 500 market index being pushed higher based on a small number of stocks related to artificial intelligence technologies. This trend may have gone too far given the imbalance between investment and profitability in this area. Due to the psychology of the market, trends tend to go too far and then reverse to correct.

Likewise, the downward trend in REIT valuations may soon come to an end. Current dividend yields are relatively high and the supply of new units will be much less going forward; The excess supply should be absorbed this year. I expect rent and dividend growth to resume next year. This should result in future returns reverting to a more normal range of 7%-11%. A spike in inflation would likely take the returns above the top of the range and that is our primary reason to hold this portfolio – as a hedge against rising inflation.

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