Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

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Investment Newsletter – January 2005

Introducing Separately Managed Accounts: Investing in Securities

Most of you consider Berkeley Investment Advisors a real estate firm, but the truth is that our business is helping smart investors keep what they have while pursuing market beating returns. As more and more investors turn to real estate, it has become more and more difficult to find deals that make sense. Consequently, my clients who know my investment record and who are not facing a deadline to buy (tax free exchangers), have asked if I could help increase returns on their liquid assets (i.e. cash). The purpose of this newsletter is to explain why you too, should entrust management of your liquid assets to Berkeley Investment Advisors rather than some other investment advisor or mutual fund.

We seek undervalued securities using our fundamental valuation expertise, our knack for understanding the financial impact of economic trends, and our ability to synthesize and quantify other qualitative factors affecting investment values. I will explain the investment strategies I employ on behalf of clients, my experience and investment track record, and the details of how the accounts will work. This will probably bore you, but if you have significant liquid assets, it will definitely be worth your time to understand what we offer and how it differs from other alternatives in the market: I have significantly outperformed the S&P 500 index every year since I began actively managing my portfolio 6 years ago.

It used to be very costly to set up the infrastructure to manage client money while meeting all the regulatory requirements. Recent advances in brokerage firm technology have reduced these costs so that now I can offer customized money management services in a cost effective way. Thus I am offering separately managed accounts for investors with as little as $50,000 to invest. By using a cutting-edge online brokerage platform, I can use my expertise to customize portfolios and still charge no more than you would pay for a run-of-the-mill mutual fund.

What it Takes to *Consistently* Outperform the Market

Lots of people earned very high returns during the bubble years and they thought themselves brilliant investors. They were not. It took a bear market to show that they had been lucky and, in fact, had no investing *skill* or viable long run strategy.[1] As an investor, I have a lot going for me: bachelors and masters Degrees in business from U.C. Berkeley (plus Ph.D. coursework), a masters degree in economics, a C.P.A. and C.F.A., plus years of banking and Wall Street experience. But when I think about what it is that makes me a successful investor in securities, I see three things that stand out from the rest:

1. Strong focus on analyzing fundamental value as derived from earnings and cash flows;
2. Big picture perspective – a solid understanding of how the economy works, current trends, and the implications for industry and company financial performance; and
3. Attention to, and careful assessment of, qualitative indicators of future performance.

The last of these deserves a bit more explanation before I illustrate how these competitive advantages tie in to investment strategies. I'm talking about understanding the stock or bond performance implications of the news and other non-financial information. Most importantly, this is about accurately identifying those companies with superior business models and strong management. (Of course it's also important to identify those companies with poor prospects and weak management in order to avoid them.) Other qualitative factors that come to mind include: accounting issues/scandals, insider transactions, politics, mergers and acquisitions.

Investment Strategy

We will implement several different strategies on behalf of our clients but the common theme of all is to find market niches where returns are high relative to the risks because of a lack of understanding or attention on the part of the big institutional players in the market.[2] Based on my investment experiences I have identified four strategies that flow from my competitive advantages versus other money managers in the market:

1. Long Term Value

[1] As Warren Buffet says, "When the tide goes out, we can see who's been swimming naked!"

[2] Note that the real estate market for smaller properties is also characterized by a lack of systematic analysis and/or institutional competition for assets. I believe this is the reason why real estate has historically been a source of high returns for individual investors.

2. Under-appreciated Income and/or Growth
3. Market Over-Reaction Contrarian Investments
4. Opportunistic Liquidity Provision

Sometimes a single stock may fit more than one of these strategies.

All long term investors want to pursue the first strategy: buying companies that consistently build shareholder value over long term. Warren Buffet follows the Long Term Value strategy and has done extraordinary well with it. Making good money with this strategy requires an ability to recognize how demographic and economic trends will affect an industry's revenue growth and competitive environment (i.e. profit margins), and a knack for identifying companies with the management talent and business model necessary to capture a large part of the value created by those trends. You must also look at the company's current valuation to make sure the market has not overestimated its future prospects or underestimated the risks it faces.

The second strategy, finding securities with under-appreciated income and/or growth, usually involves smaller companies not well followed or understood by Wall Street. Here we are looking for companies that already generate substantial free cash flow, who have good prospects for moderate growth in cash flows, but whose stock valuation is low relative to current cash flows. For example, a company that is already generating earnings equal to 8% or more of its stock price would be a very good deal if we could be confident of 10% annual growth in such earnings. Such earnings are even more valuable if the company pays out a substantial portion as dividends because this cash goes straight into our bank account; we don't even need the market to realize the value of the earnings stream to receive our return. Fundamental valuation and qualitative risk assessment are important to finding these opportunities.

My third strategy is my favorite because it can really enhance a portfolio's returns. Unfortunately these opportunities do not happen very frequently so you must use other strategies and patiently wait for an "event" to happen. What I'm talking about is big news that causes institutional players to overreact by selling off a security far below its real value. By correctly estimating the economic impact of news and accurately assessing the fundamental value of a security being sold off by the market, we can bravely buy when others are selling in panic. Such contrarian trades pay off big when the market calms down and enough investors realize that the worst case scenario has, in fact, not happened.

The fourth strategy is best explained in the context of market structure. Liquidity is the ability to buy or sell shares without significantly affecting the price with your transaction. Wall Street firms provide liquidity by standing ready to buy at their bid price or sell stocks at their ask price. On average they get paid the bid-ask difference as their compensation for this service. What I call Opportunistic Liquidity Provision is a longer term version of this market making function. What we look for is a good company that we understand the long run value of, which is relatively thinly traded. In this situation we will observe the stock price fluctuating[3] around its true value with significant deviations in the absence of news. We can profit from this by providing liquidity to sellers at our bid price (the low end of the trading range) and liquidity to buyers by selling at our ask price: the "true" value of the stock (near the high end of the trading range within which the stock fluctuates). There is always some risk that some news will go against us while we're waiting for the buyers to show up. For this reason we use this strategy only on stocks that we are confident will pay off in the long run as well as the short term (i.e. they also fit another strategy).

Results Using These Strategies

In the interest of brevity, I will limit my discussion of specific examples in this newsletter but I would be happy to share more details with anyone who is interested. Over the last 6 years I can identify several major "themes" that illustrate the strategies. My first investment theme was profiting from the turmoil in emerging markets in the late '90's. I bought Russian bonds, Brazilian bonds (also 2003 election), and a Mexican cement company when the big institutional traders were selling like crazy to meet margin calls. Then, in 1999 I started buying Real Estate Investment Trusts (REITs) when they were out of favor and continued to buy underappreciated companies until the market finally recognized their value and bid them up to what I consider "true" value. Next, I bought companies that were over-sold in the wake of 9/11 (mostly re-insurance). More recently, I profited from the Freddie-Mac accounting scandal and the Insurance industry scandal - thanks to short-term market mis-pricing of these securities.

On an absolute return basis I have done very well. My annualized rate of return over the six years ended 12/31/2004 is 19.4%. You may not think much of this until you realize that this period covers one of the worst periods in market history. The S&P 500 index return over this period was just 1%. Cumulatively this means that $100 invested 6 years ago in the S&P 500 would have grown to $106 while my $100 grew to $290. Not only did I beat the market by 18% annualized over a 6 year period, but I also beat it consistently. By this I mean I

[3]Such fluctuations are referred to as "noise" and those causing it (by trading) are called "noise traders". What is meant is that the trades are not done on the basis of information but for other reasons such as asset allocation or estate settlement or whatever.

outperformed the S&P 500 every single calendar year over the 6 year period. (See **Appendix A** for a detailed comparison of my record to the S&P 500).

Now I must admit I am not infallible, I have made investing mistakes. In 2002 I converted a lot of my positions into options positions. Time worked against me instead of for me and I experienced my only losing year. Even so, I still outperformed the S&P 500 by 7.7%. Still, I've learned, from the few errors I've made, so that I now invest with humility and caution. After all, preservation of capital is first priority. Still, investing always involves risks; see the disclaimer below.

Risk Management

So how will I protect your capital while pursuing market beating returns? I manage risk through diversification, rebalancing, calm reassessment in the face of new information, and a disciplined adherence to strategy. I will explain.

Diversification means spreading out your money so no single investment can cause a "significant" loss all by itself. We have three ways to pursue diversification. Most importantly, portfolios will include many different stocks and no portfolio will have more than 10% of its value invested in one company. Second, the use of exchange traded funds (ETFs) to invest in a specific industry or country provides diversification because these securities represent investments in entire portfolios of companies within the target sector or country. There will be different portfolios for different risk tolerance and objectives. Thus a final source of diversification is spreading money out across more than one of these "risk portfolios".

Rebalancing refers to selling assets that have risen and investing in those that have fallen in value so as to hold the individual positions somewhat stable as percentages of the total portfolio value. Notice what this policy calls for: selling high and buying low. This is the most basic rule of making money. It's also the opposite of what most people seem to actually do. Discipline is needed because buying something that has been declining brings emotion (regret, fear) into the decision process. Likewise selling something that has been good to us can also go against our emotions. Of course, there will be some constraints on sales of winners to avoid situations where the resulting tax liability negates the gain from diversification. As I will discuss next, there will also be some cases where we should sell a declining stock.

We do not want to add to holdings of a declining stock when the decline is for a good reason. Thus, when new information comes out that causes a price decline, we must analyze the new information to determine if it changes the likely returns of the stock going forward. We must be calm in re-assessing the situation. When emotion and panic drive the rest of the market, those who keep their wits make all the money!

The Product: Risk Tailored Portfolios

Based on each client's investing horizon, risk tolerance, and return goals we will recommend spreading their money across four tailored portfolios summarized in the following table.

Portfolio Name	Risk	Example Investments
Parked Money	Very Low	Short term bond ETFs, variable rate preferred stock
Long-Term Income	Low	Longer term bond ETFs, fixed rate preferred stock, mortgage REITs
Long-Term Value	Moderate	Stock picks: Long Term Value strategy, Under-appreciated Income and/or Growth strategy
Special Situations	Market	Stock picks: Market Over-Reaction Contrarian strategy, Opportunistic Liquidity Provision strategy

In the future we will offer a Quantitative Trading portfolio based on back-tested trading systems[4]. This portfolio will be designed for clients willing to take higher risk in pursuit of very high returns.

Separately Managed Accounts: Customized Client Portfolios

A separately managed account means that a separate brokerage account is maintained for each client and the Investment Advisor buys and sells securities in the account on behalf of the client. In such an account, the investment strategy can be tailored to meet the client's individual return goals and risk tolerance. Also, the client (or Investment Advisor) can control the timing of tax gains and losses precisely and thereby manage tax liabilities. Contrast this to a mutual fund where you are investing alongside many other investors in a portfolio based on one particular strategy. First of all, a fund's strategy may never exactly fit your own objectives precisely. Then, through time, your goals may diverge even more from those served best by the fund's strategy. When this happens you must close the account and look for a new mutual fund that follows a strategy more closely related to your own objectives. In addition, you have no control over the timing of taxable transactions in a mutual fund.

The reason most people have not heard of separately managed accounts is that most investment advisors will not provide this level of service until you have a relatively large amount to invest. You need at least $100,000 in liquid assets to find an advisor to manage your account separately; most will require a much higher minimum level of assets. Fees on such accounts depend on the size of the account. Typically fees start at a relatively high 3% per year and slowly

[4] By this I mean we will use historical data to verify that a set of quantitative trading rules would have earned high enough returns in the past to more than compensate for the risks taken.

decline with account size. It's not till you get to the $1 million mark that management fees drop to a more reasonable 1% of assets. Note that trading costs come on top of these fees.

Berkeley Investment Advisors uses the FOLIO*fn* online brokerage platform to provide a much more cost effective solution for our clients. FOLIO*fn* enables us to customize well diversified portfolios for small accounts at much lower costs. Combined management and brokerage transaction fees are 1.4 % of assets annually with a minimum annual fee of $1,300. For accounts of $100,000 and up, this is comparable to the cost of a mutual fund.

All monies and securities will be in the custody of FOLIO*fn* and they will provide monthly statements and tax accounting for transactions. Note that there is complete flexibility in determining which shares are treated as sold when computing gain or loss for tax purposes. FOLIO*fn* is a member of the Securities Investor Protection Corporation (SIPC), a non-profit corporation that provides account protection to customers of registered broker-dealers[5].

Disclaimer

Despite my past record, clients should not assume that the investments I make on their behalf in the future will be profitable or match past performance. FOLIO*fn* does not offer the ability to do any of the following:

- Borrow on margin to leverage positions
- Short sell securities to profit from price declines
- Buy or sell individual bonds
- Buy or sell options, futures, or any other types of derivatives.

In achieving my past results I made use of most of these capabilities at one time or another.

Conclusion

The bottom line is an opportunity to access superior investment management services customized to meet *your* investment objectives without paying any more than you would for an actively managed mutual fund.

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[5] SIPC protection does not cover losses from declining investment values. Rather, it protects investors against losses that stem from the financial failure of a brokerage company. If a brokerage fails, SIPC will cover losses up to $500,000 (with a limit of $100,000 for cash losses).

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Appendix A

		Ray Meadows Portfolio *	S&P 500	Difference
Calendar 1999		75.6%	20.4%	55.2%
Calendar 2000		1.0%	-9.8%	10.8%
Calendar 2001		10.2%	-12.1%	22.2%
Calendar 2002		-13.9%	-21.6%	7.7%
Calendar 2003		34.2%	28.2%	6.1%
Calendar 2004		28.5%	10.7%	17.8%
6 years ended	12/31/04	19.4%	1.0%	18.4%
5 years ended	12/31/04	10.6%	-2.5%	13.0%
4 years ended	12/31/04	13.1%	-0.5%	13.6%
3 years ended	12/31/04	14.1%	3.6%	10.5%
2 years ended	12/31/04	31.3%	19.1%	12.2%
1 years ended	12/31/04	28.5%	10.7%	17.8%

* Note that these returns are not representative of future returns because the FOLIOfn platform does not provide capabilities to use margin, short sales, options, and other derivatives. Nor can individual bonds be purchased.