

Welcome to Money For the Rest Of Us Plus. This is the premium podcast episode for Plus members. I'm recording this Friday, March 29th, 2019. This is Plus episode 246. In this episode I have some follow-up regarding the central bank episode that I just did, in terms of interest rate policy and what the market is pricing in, in terms of interest rate directions. I wanna talk a little bit about some portfolio trades I made in the current investment environment.

We are going to talk about private real estate investment trusts, so private REITs versus public REITs, and then I have a question from a member regarding an investment that he thought would protect, or would actually maybe generate a positive return when the stock market sold off, and it turned out to actually have losses in the 2018 market decline, so we'll take a look at that particular investment.

In episode 246 of the regular podcast I implied, but in relistening or listening to the episode, I should have been more clear. The reason why interest rates are falling right now is because the expectation from the market is that the Federal Reserve will cut interest rates in the next year; they'll start lowering their policy rate. But the yield curve—the plot of interest rates—right now with cash, 30-day Treasury is at 2.5%, the 10-year Treasury is just about there, but the 30-year Treasury is higher than that, at 2.8%. So the yield curve is kind of U-shaped, which means that the market is assuming that the Federal Reserve will cut interest rates over the next year or so, but Fed policy five years out will be raising rates again; so it's more of a U shape. So I wanted to sort of clarify that.

The Federal Reserve doesn't think they're going to cut rates; they don't want to cut rates, because of the fact that the Fed Funds rate is only at 2.5%. They would much rather be at 3.5% or higher, and so be able to resume raising rates this year or next year, depending on how the economy evolves. That would give them more ammunition to cut rates when the recession comes. So that's what they want to do. We'll see what happens. All we can do is monitor investment conditions.

But in this environment I'm sort of thinking, "Well, what do I want to do in my portfolio?" I don't want to add long-term bonds, which as we've talked about in other episodes, would be something you could do if you're being paid for that. But clearly, the bias is now for the market that rates are falling, but you're not compensated for taking long-term interest rate risk. So what I did instead is I've added preferred stock this month. Preferred stock—I mentioned the Gabelli preferred stock that I added earlier—I've now added some preferred stock by the mortgage REIT Annaly Capital Management. It's a long-duration asset, because preferred stock doesn't necessarily mature; it can be redeemed at some point, but it tends to be very long-term. So if interest rates go up, it won't do so well.

But in the meantime, with the bias toward interest rates falling, you actually get a nice yield. In terms of the Annaly Capital preferred series, I bought the G Series, that pays 6.5%, and the F Series, that pays 6.95%. These are mortgage REITs. All mortgage REIT is—it's a company that issues common stock shares; they use leverage (debt), they borrow money, they issue preferred shares, and with that money they go out and they buy mortgage-backed securities. What they're trying to do is get a specific yield on a mortgage-backed security, and because they're using leverage, they try to create a dividend for their common stock shareholders of very high—close to 9% or 10%. That's their business model, and Annaly Capital has been doing it a long time.

The common stock can be volatile, because the leverage is there, and in a scenario when interest rates are falling, Annaly has to worry about prepayment risk; as borrowers refinance their mortgages, they tend to hedge the interest rate risk over the next year or so, so they have some protection. But

this is basically just a strategy where they have leveraged assets; as part of that, they issue preferred stock, and as I mentioned a few weeks ago, most preferred stocks are issued by banks. I'm not necessarily comfortable owning a bunch of bank preferred stock, particularly if we end up in some type of recession. But I'm comfortable owning a mortgage REIT that's been around for many years, with a fairly simple business model, a lot of transparency there; I'm comfortable doing it for a closed-end fund by Gabelli. Again, simple business model. Not risk-free, by any means. I mean, there's definitely risk there, but I feel like I'm being compensated for the risk. So I've made those portfolio changes this month, in my personal portfolio.

I'm not necessarily ready to add preferred stock to the model portfolios, mainly because if you noticed how I bought these, I've bought individual securities, with specific companies. I'm not comfortable adding a broad-based preferred stock ETF because again, it's very bank-heavy, and that's not just something I would be comfortable doing, so they're not in the models. But they are in my portfolio.

On the member forums there was a question on private REITs. It was about a year ago that we increased the allocation to real estate investment trusts, public REITs, in the models; I added them to my portfolio. REITs have done very poorly at the beginning of 2018. They were selling as cheap as they'd been in a number of years, and so we added them. Since then, REITs are up over 20% year-over-year, so that's been a good investment. But a member is thinking about "What about a private REIT? What's the difference between a public REIT and a private REIT?" The member mentioned that presumably you can earn more, generate a higher return with a private REIT. Not necessarily. It kind of depends.

He listed out in the post three different private REITs—one by Oaktree, one called USQ Core Real Estate Fund, and one by Nuveen. All very, very different. We're going to take a deeper dive into the Oaktree private REIT. But the USQ Core Real Estate Fund is actually more of a fund of funds, so it's allocated to 16 private fund managers. The particular real estate fund charges 1.2% expense ratio, and then all those underlying funds are going to charge their hefty fee.

Nuveen Global is a city REIT, so it's investing in office buildings around different cities around the globe. Its expense ratio was the lowest of all of them, just 1.25%, but because there's no underlying manager—Nuveen is the underlying manager—it's a fairly attractive fee. And they've invested 300 million dollars in this strategy, of their own money.

But I wanted to focus on Oaktree. I used to invest with Oaktree as a money manager, in terms of as a consultant to endowment clients; I had a number of university clients that invested with Oaktree, primarily in their distressed debt strategy, rather than the real estate. But they've had a very good real estate team, institutional real estate team, and they have a private REIT that they came out with a year or so ago.

The difference between a private REIT and a public REIT is the private REIT is not listed on an exchange, so you can't just sell your holdings. They have a buyback program. They're calling this a perpetual life REIT, and they will buy it back at the prior month's net asset value. But there's a limit to how much they will buy back. I think it's limited to 2% to 5% of shares outstanding, and if you sell within the first year you've owned it, you take about a 5% haircut, you only get 95% of... Basically, it's

like a back-end load, because they're supposed to be illiquid, so you're not supposed to sell them after a year.

It's invested in commercial real estate, many different types. They also do some debt, commercial mortgages. The reason why most private REITs do better than public REITs is they use more leverage. This particular private REIT will be using \$50-\$60 of debt for every \$100 of assets that they buy. Their chart here says they can use up to 75% debt. If we compare that to your typical public REIT —this is data from Nareit—they have about \$35 of debt for every \$100 of assets. So they have less leverage.

Leverage is good when the market is doing well and property values are increasing. But leverage is leverage; it can increase the return, but it could magnify the losses.

I mentioned the liquidity issue with the private REITs, so yes, if you sell within the first year, you only get 95% of the NAV, so you take about a 5% haircut. They will redeem 2% of shares outstanding per month, and 5% per quarter. This is an expensive product.

Our comparison here, the public REIT, the Schwab US REIT exchange-traded fund expense ratio is 0.07%. For the Oaktree private REIT there's a selling commission for the T and S class shares, which have a \$2,500 minimum; it's about a 3.5% commission upfront. Then there's a stockholder servicing fee of around 0.85%, plus the management fee of an additional 1%. So annually, there's a 1.85% expense ratio, and then you've got that 3.5% commission. Then there's what they call "performance participation allocation". Oaktree will get 12.5% of the annual return, anything above a 5% hurdle rate.

As I calculated, if the fund returns 12%, that participation amount ends up being about 1%. At a 12% return, the hurdle rate is 5%, so basically we get 12.5% of a 7% return. That ends up being about 1% or so.

So all-in, the fees on an annual basis is 2.85%, assuming they earn 10%-12%, compared to 0.07%. That is pretty expensive. Not that I don't invest in private real estate; I am invested in some institutional private real estate funds. The fees are lower than that, but I'm more comfortable doing it in—if we were not where we are in terms of the real estate cycle, if valuations for private real estate were much cheaper than they are today.

These managers are going to have to work hard to find compelling opportunities, because we're late in the real estate cycle. So if you prefer liquidity and lower fees, go with public REITs; if you want the potential higher returns because of the use of leverage, then you can use a private REIT.

I'm not necessarily convinced that a private REIT is going to be better at selecting investments; they're competing with the public REIT markets for these assets. Somebody like Oaktree perhaps they have more of a network, but bottom line is it's the leverage that delivers it.

Final question then—this is from a member that had bought a WisdomTree product; it's the WisdomTree CBOE S&P 500 PutWrite Strategy Fund. When he bought it, he says his expectation was that in an up market the upside of the investment would be muted, and in a drawdown there would be some potential upside, perhaps even a positive return. This strategy was tested in 2018 and failed. The S&P 500 was down 4.4%, and PUTW was down 7%. In the up markets of 2017 and early 2019 the

PUTW has also lagged the S&P 500. So in the short-term, it has successfully under-performed in up and down markets.

"Well done", he writes. "I did some further research on these PutWrite strategies. It could be a bit more technical than I was interested in reading, so I took my loss and moved on." So he sold the investment.

I looked at it. The investment is not what he thought it was. Whenever you invest in an ETF like this, the first thing you want to do is see what index it's tracking. ETFs track specific benchmarks. This is tracking the—the ticker for the index is PUT. It's the CBOE S&P 500 PutWrite Index. So that's what it's tracking.

The way that this works is the Chicago Board of Exchange hired a consultant, EnnisKnupp, to do some research—this was back in 2007—to create the index, the justification for it etc. Here's how the index works. It doesn't have any exposure to the S&P 500 at all. It's not bought S&P 500 stocks. Most of the assets are in Treasury Bills, and then it's selling/writing put options at the money. So the S&P 500 right now is about \$2,800; it's selling one month out put options.

Today put options are expired. You can buy a 30-day put option, or you can write/sell one. They're getting the option income, the premium income. That's what the return is driven by. But with a put, if you sold a put, you're exposed to any losses at all; you're paying that out. So this is the exact opposite—this is not a strategy to protect against market losses. Every dollar market loss gets paid out. That's money lost. 100% exposure to the downside.

The upside—there's no exposure to appreciation of the S&P 500, it's all the option premium income. I went on and looked at the price of options. If you bought an option right now—I'll just base it on the S&P 500 ETF. If you bought one contract, it would cost \$374. That would cover about \$28,200 of exposure to the S&P 500; your yield, your return. So they would have \$28,000 in Treasury Bills that would match this one put option that they sold. So that's about the \$374 divided by \$28,200 is 1.3% per month. If the S&P 500 rose in price, and option pricing stayed the same, this fund would earn 16% a year, just based on the option income, based on what the VIX is priced at, or what options are priced at right now.

But if any of those months the stock market fell, then that 16% would be reduced. So the upside is 16% return, the downside is unlimited based on what the market is doing. But again, these put options expire in 30 days, so every month it's reset.

The reason why you want to look at how the index has done is they'll have done a backtest to see how would it have performed. And particularly you want to look at how it has done in the 2008 period, because again, we're looking at monthly timeframes. So the worst loss was in October 2008. The index would have lost 22%. It would have lost 12% in November, 2008. That's how it would have done.

How has the index performed over the long-term? It's done fine. It's trailed the S&P 500. But again, this is an income strategy. Over the past three years it's done 6.4%, it's done 5.5% over five years, and then over ten years it's done 9.3% annualized, and over 15 years it's done 6.6% annualized.

This is a strategy that potentially can earn 5.5% to 6.5%. That seems reasonable to me, based on the index. But I guess you could say it's a—I don't know if it's a diversified return driver. You're getting option income, but you're exposed to the downside of the market, completely exposed.

One of his questions, as I was going through this—what if he just wanted to protect against greater than a 5% loss? What would that cost? Because I mentioned— if you want to buy put options and be protected against the stock market falling, in the same way this strategy is doing, you would buy put options at the money, every month, and the drag on your portfolio would be 16% per year. That wouldn't make any sense. But if you just wanted to be protected against— you'll take the first 5% of the loss, and be protected for anything greater than that, that will cost (based on current option pricing) 3.4% per year. So your return, whatever you return on the S&P 500 would be reduced by 3.4%. Which is still sizeable.

In episode 240 we looked at the Innovator Outcome-based ETFs; the Buffer Protect Index Series is what it was. Again, this is another CBOE index, and in this case what it would do is—the particular strategy we looked at was the S&P 500 30% Buffer Protect Index Series, where you take the first 5% of the loss, and then you're protected from -5% to -30%, and anything over 35%, you take that loss. Now, that also returns 5.5% going back to 2006. It trailed the S&P 500. Which you would expect, because these strategies are less volatile than just owning stocks, and they've returned 5.5% to 6%.

I haven't invested in them, mainly because I like more straightforward ways of earning money. I would rather own preferred stock, or buy closed-end bond funds, or something along those lines, or own real estate investment trusts. I like simple investments, but you're getting more of this type of products out there; in fact, I'll probably do a podcast episode on this in the near term. Just how many indices are out there, and talk about what we're seeing here as more and more products come out, to help investors that are worried about market drawdowns.

The first rule of investing is "Know what it is, be able to explain what it is, and make sure what you're buying is what it is." When I first looked at this particular ETF, I was sort of the same way. I thought it actually owned the S&P 500. It didn't even actually own the S&P 500, it owns Treasury Bills, and then sells put options.

That is Plus episode 246.