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DIVIDEND STRATEGY

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"Casual Friday" Commentary

Casual Friday: CRE Crisis? + "BOA" Part 2 – September 1st, 2023

#TGI- EARLY Casual Friday!
2 beefy topics, albeit Labor Day

Commercial Crisis?
Advisors fretting over the "next 08" often point to commercial real estate write-downs as a potentially "destabilizing event". Higher rates, work from home, and recession fears all threaten commercial real estate – particularly office-related properties.
Are the fears warranted?

By the numbers:
Today's CRE debt exposure in the banking system? About $3.5 Trillion – roughly $1 Trillion is specifically tied to office space -- a far cry from the $14 Trillion mortgage market of '08. Plus, the US GDP is roughly double that of '08 and to boot, "toxic derivative fuel" that torched the entire mortgage and banking industries in '08 isn't visible at the moment or in the news – so far (hopefully 08' lessons were learned). Exposure? Not zero – but seems far more manageable. (Source: Bloomberg)

CRE Valuation: A Lot Like Bonds, Equities:
Like most investable assets, commercial real estate values are derived in a formulaic approach, three variable approach similar to bonds or equities: Risk-free rate, a risk premium, and the cash a property generates. Higher rates mathematically drive lower valuation as does the lower rents from companies choosing not to renew. If workers are at home, the demand for office space declines. It's like when a stock: earns less and experiences P/E contraction.

It's important to note the confluence of two factors: Banks offer many CRE loans with a 20-year amortization and a 5, 7, or 10-year maturity but the leases are typically 3 to 5 years. Pre-pandemic loans are maturing at a time when fewer and fewer are signing a new lease.

How are banks responding?
They're slashing building valuations on CRE mortgage renewals, asking developers and owners to bring additional collateral to the table, and attempting to swap paper with one another. Pockets of fallout are likely to make the news. Estimates show Office CRE valuations declining roughly ~30%. We've heard anecdotal stories of ~60% markdowns. Most of the larger banks don't have material exposure and are very likely capable of navigating

write-downs and workouts on these loans. The smaller banks are more exposed and geography matters at the moment. We continue to monitor. (Source: Bloomberg)

Berkshire Bank Exposure?

Berkshire's Dividend Strategy owns 4 of the largest capitalized banks in the U.S. – JPM, BAC, PNC, MTB. The CRE exposure is well documented. The old adage "if it's in the paper, it's in the price" may ring true here. The problems are not a secret. They're trading at sizeable discounts in our opinion. The average dividend yield of these banks is roughly 3.6% (Source: Bloomberg) and loan underwriting is historically impeccable for this carefully curated list of companies in our portfolio. Throw in very high capital ratios and we're confident these 4 banks can survive this wave. Many of the credit executives who successfully navigated 2008 are still in place at each of the banks. We did trim some exposure in the space earlier this year but we do believe there's ample long-term upside in the stocks, barring a steeper recession. Each of these banks committed capital last month to increase dividends or stock buybacks, a pretty good indication none of them are overly concerned about heavy credit losses, at the moment.

Blue Ocean Advisor ("BOA") Part 2

"You need me, but not as much as Wall Street Wants you to THINK you need me." was an introduction we advocated last week as we discussed how the book Blue Ocean Strategy could help advisors create meaningful differentiation.

It's the opening section of a 4-part approach that differentiates an advisor's services by showcasing: simplicity, transparency, and client empowerment vs. creating contrived dependency of: complicated, opaque and hard-to-understand.

We went on to highlight how an advisor might demonstrate how a few simple concepts, that are largely under the clients' control, could be the real keys to investment success – and be a business-building foundation. If we could get client buy-in, it would likely keep them feeling peaceful, loyal and disciplined. The quality and demeanor of your client base are really what determines the value of your business (and your life). If clients are calm and centered, you'll be calm and centered - and therefore more prosperous.

We identified 6 concepts that you might position as the real keys to financial success" (We have a bank of supporting charts. Call for details)

Slide 1: "Control Your Spending Rate"

- Few things have a greater impact on client terminal wealth, in our opinion. Explain how you'll help create a disciplined approach to spending policy.
- Tell them what they need to hear, not what they want to hear and don't promise rates of return that defy reality. Natixus surveys show clients expect north of 12% annually. It's paramount to set them straight or let them walk.

- Show how even a simple $5-a-day latte adds up to tens of thousands of dollars in lost assets later.
- Bigger picture, demonstrate the value of cash-generating assets like leased real estate, dividend stocks and business activities vs. cash-gobbling consumption assets like expensive cars, yachts and vacation homes. These things rarely hand you cash at the end of the year.
- "Consumption really is the enemy of wealth."

Slide 2: "Don't Chase Yesterday's Winner"

- The Dalbar study shows time and time again that investors usually underperform the very funds they are invested in – by a wide margin. How can this be? Fixation on recent past returns and only buying "what's hot now"
- How many clients have the discipline and fortitude to add money to asset classes or strategies that are out of favor or even mundane – yet we believe these are what preserve and grow wealth?
- How many times have you seen clients want to buy the latest and greatest – only to have it tank soon after?
- Don't let clients miss the wedding and show up for the funeral. Growth stocks in 2000. Real estate in 2007. Commodities in 2008. They all looked great based on past returns and sexy growth stories. AI in 2023?
- Death...taxes...and client performance chasing

Slide 3: Get Stock/Bond Allocation About Right

- Articulate the following: "If you can't handle **some portion** of your portfolio dropping 20, 30, 40% at any moment – then don't own stocks. Equity drawdowns are more common than you think, and they are really hard to know when to get out, and maybe even harder than it is to get back in"
- Show them a matrix (we have one so if you'd like to see it call us) that shows potential one-year worst-case scenarios at different stock bond allocations. "Could you handle your account being down 40%? 30% 20% in any one year? If not, we'll need to ratchet up the bond/cash allocation." Blend accordingly.
- Nothing is more unproductive to an advisor's practice than answering/discussing/arguing over "Which way is the market going?" "Should we sell?" "Should we buy?" Season clients – "There's no crystal ball – period."

That way when the inevitable 30% correction hits:

- A – they won't be surprised – you told them to expect it.
- B – when their balanced account is potentially 15-18% (or whatever amount they said they could handle) they will likely take it in stride. Subtle but huge.

Slide 4: Don't Pay Too Much In Taxes
This is where planning prowess pays off. Get a specialty. Go back to school. Really learn tax-friendly retirement distribution strategies, trusts, estates, gifting, exchange funds, and executive comp plans. Don't just kinda "know it" be a true expert. Tax savings is also a great prospecting tool so if you are the boss of retirement plans, tax-friendly exit strategies, you'll get in front of a lot of wealth prospects. Remember – if you solve big problems, you'll likely get big assets.

Slide 5: Keep Fees Reasonable Dare I Say…Low.

- I'm sure I'll attract blowback here but I truly believe based on the overwhelmingly favorable economics and scale of the asset management business positioning services below the industry average is smart.
- Compete below the national average. Get a market share strategy. Explain how a lot of complicated potentially high products like annuities, alts, and hedge funds could skew the odds to the group selling it – and should be used sparingly. A little rant against some of the wrong industry practices shows you are the clients' side.
- Keep your fees easy to understand, transparent and below the average.
- Consider articulating a middling pricing strategy "Yes, it costs more than an index, robo options but is far below what most advisors typically charge."
- Quantify how putting an extra X bps in fees in the client's pocket at some rate of return adds up over time.

Slide 6: Basics of Compounding
Show the growth of X dollars at various, even modest rates of return add up over 20 years and articulate how if you and the client can set up a strategy to just "get out of the way" odds of success are pretty good. Like Charlie Munger - Buffett's partner said "Compounding works best when its left uninterrupted."

Conclusion:
I'd argue effectively implementing these 6 concepts is a more reliable way to attract quality clients and create higher terminal client wealth than all the investment / razzle dazzle the industry seems to espouse.

Most advisors imagine creating a differentiated message that attracts big clients. We've seen advisors win big with this approach.
Most advisors often feel their business runs them not the other way around. Imagine the scale and efficiency you'd get by implementing these concepts into your practice.

Like we said last week – "Simple is Smarter" and creates an entire business building platform you can build your career around.

We'd be happy to show you how.

Next week we'll share how to shape the investment plans – onto one simple slide.

What are your long weekend plans?

1. U.S. Open Tennis?
2. Start of College Football?
3. BBQ/Picnics?
4. Re-reading Casual Friday and implementing the concepts in your practice?

Have a great weekend,
Gerard Mihalick, CFA

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