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Q3 2025 Outlook

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02 July 2025

Dollar Dilemma

By Michael Crook, Chief Investment Officer

The global economy appears to have been resilient through the tariff uncertainty of the last three months. Consumer and business owner sentiment remains subdued but has stabilized since April. More importantly, hard economic data shows little sign of a slowdown. Inflation remains slightly elevated but very close to 2%. The labor market remains solid. However, in a sign of increased worry about the future, quit rates and hiring rates have declined.

From a market perspective, US interest rates have returned to approximately the same levels as at the beginning of April. US and international equity markets are higher than on "Liberation Day" and nearly back to all-time highs. Twelve-month forward equity earnings forecasts have declined slightly but not enough to change anyone's outlook on the market. Outside of sentiment and actual trade data, it is hard to pinpoint a significant market impact from tariff policy thus far — hard to pinpoint, that is, unless one checks the currency markets. The dollar has declined 10% against other developed market currencies this year, which has many investors wondering if the decade-long US exceptionalism trade has come to an end.

The current account deficit

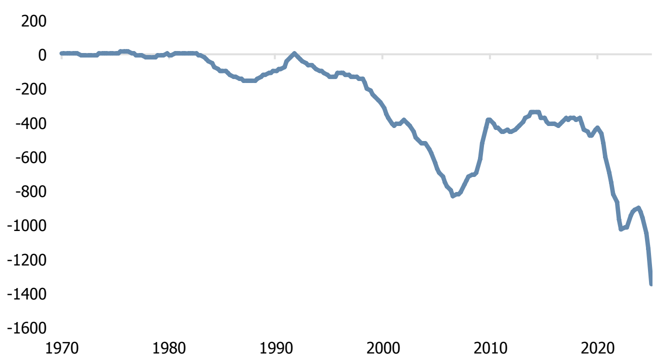
When a country isn't saving enough to fund its investments, and the government is also spending more than it takes in, the country has to cover the gap by borrowing from abroad. This amount is called the *current account deficit*.

A slightly different way to think about the current account deficit is that it is equal to the trade deficit plus the net interest, dividends, and other investment returns owed to foreign holders of US assets. Fiscal deficits accumulate into an ever-growing national debt and, absent a reduction in the trade deficit, drive the current account deficit higher and higher.

An unsustainable current account deficit (i.e., foreigners become unwilling to finance a country's borrowing needs at reasonable interest rates) is traditionally rebalanced in one of two ways: a substantial decline in the value of the country's currency against their trading partners or a deep recession. Currency depreciation makes a country's exports cheaper on the international market and imports more expensive at home, thereby reducing the current account deficit. A deep recession also reduces demand for imports, albeit in a more economically destructive way.

Economists and investment strategists were very concerned about the US' current account deficit in the early 2000s. At the time, a historically large trade deficit led to a current account deficit that exceeded $800bn, or 6% of GDP (Fig. 1), per year. US policymakers accused China of currency manipulation, and Senators Chuck Schumer and Lindsey Graham introduced legislation that would impose tariffs of 27.5% if China refused to allow the yuan to strengthen against the dollar.

Fig. 1: US current account deficit (billions, USD)



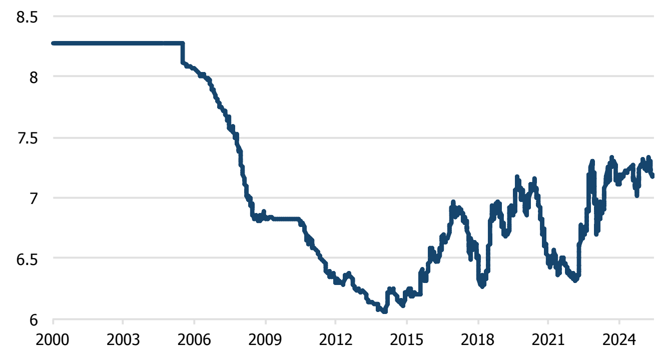
Source: Bloomberg, Mill Creek. As of 3/31/2025.

In response to US pressure, China abandoned its peg to the dollar in mid-2005, and the dollar declined by about 20% against the yuan between 2005 and 2007 (Fig. 2). As would be expected, US exports became more attractive on the global market and our current account deficit declined. Exports increased from 9% of US GDP in 2004 to 13% of GDP in 2008. The deep recession that started in 2008 reduced import demand even further and, by mid-2010, the current account deficit was back to a more sustainable -2.5% of GDP.

2014–2024: Twin deficits and American exceptionalism

The post-global financial crisis path for the United States, which we characterize as starting in 2014 and ending in 2024, was marked by a deteriorating trade balance, large fiscal deficits, and a dollar that appreciated 30% against our trading partners. These related phenomena have once again left investors wondering how much longer foreigners will be willing to fund our current account deficits.

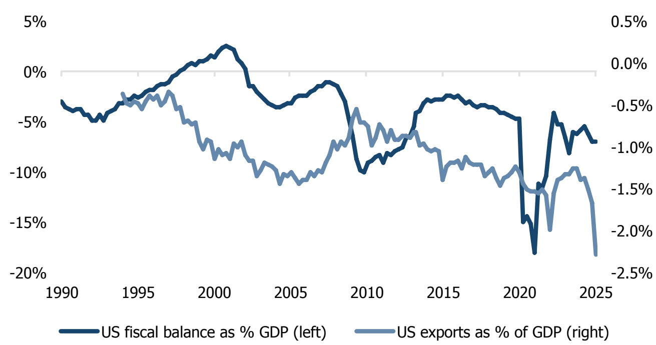
Fig. 2: Renminbi / USD exchange rate



Source: Bloomberg, Mill Creek. As of 6/20/25.

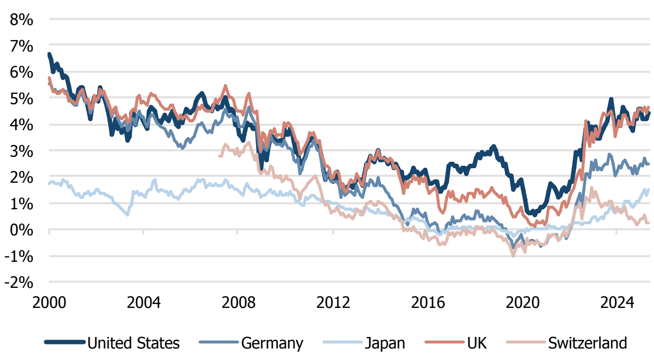
Over the last decade, increasingly large federal fiscal deficits (Fig. 3) required significant borrowing in the Treasury markets, which, along with relatively high economic growth, pushed US interest rates above those in other developed countries (Fig. 4). Foreign central banks stopped accumulating USD reserve assets around this time, but high Treasury interest rates attracted private capital from abroad, which led to an ever-strengthening dollar. A stronger dollar made our exports increasingly less attractive on the global market, creating a wider and wider trade deficit. Wash, rinse, repeat, and today we have a $2tr budget deficit and a nearly $1tr annual trade deficit.

Fig. 3: United States' twin deficits



Source: Bloomberg, Mill Creek. As of 3/31/25.

Fig. 4: 10-year sovereign bond yields



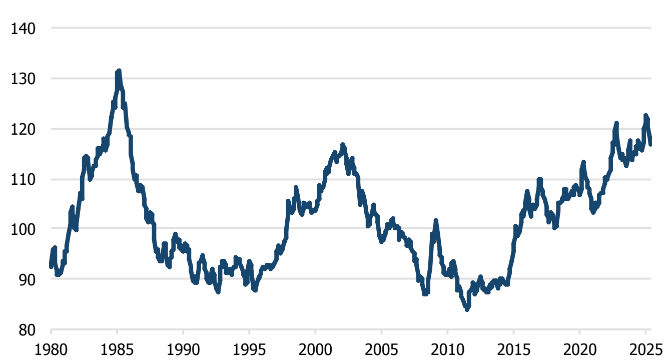
Source: Bloomberg, Mill Creek. As of 6/20/25.

It's different this time

Our current situation is similar to the mid-2000s in a few ways:

- The US dollar is extraordinarily strong on a trade-weighted basis (Fig. 5),
- Exports, as a percentage of US GDP, have fallen back to mid-2000s levels,
- China has re-weakened the yuan against the dollar (Fig. 2), and
- Policymakers are agitating for a rebalancing of trade relations with China.

Fig. 5: Fed Trade-Weighted Real Dollar Index



Source: Bloomberg, Mill Creek, as of 5/31/25.

There are also many important differences between now and 20 years ago:

- As discussed, our fiscal situation is far worse today than in the early aughts,
- The Trump administration has focused on tariffs instead of currency manipulation to rebalance the trade deficit, and
- *The marginal "dollar buyer" since 2014 has been private investors seeking higher returns, not state-owned enterprises purchasing yield assets.*

The last bullet point is worth considering in light of the (now eliminated) section 899 in the initial House reconciliation bill, which allowed the Treasury to override existing tax treaties and subject $290bn of foreign investor income, dividends, and interest to additional taxation.[1]

> *A reminder: The current account deficit is equal to the trade deficit plus the net interest, dividends, and other investment returns owed to foreign holders of US assets.*

The 2025 policy toolkit forces us to amend the introductory paragraph to this article. It should say: An unsustainable current account deficit (i.e., foreigners become unwilling to finance a country's borrowing needs at reasonable interest rates) ~~is traditionally~~ can potentially be rebalanced in one of ~~two~~ four ways: a substantial decline in the value of the country's currency against their trading partners, a deep recession, tariffs, or raising taxes on foreign investment.

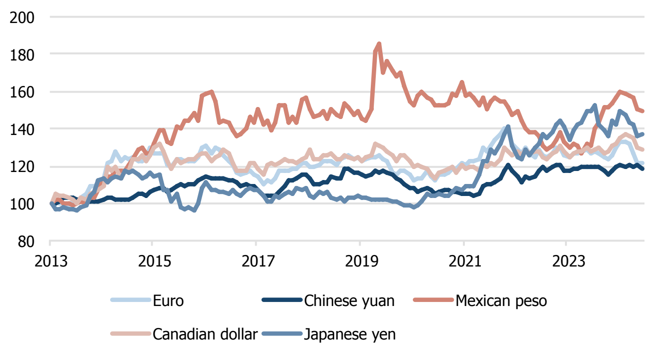
Tariffs are a policy-oriented mechanism that reduce the trade deficit by artificially suppressing import demand. Foreign investment taxes are a policy-oriented mechanism that reduce the expected foreign taxes on US assets. While these are not traditional market-based solutions, they are both top-down solutions (inefficient, to be clear) that policymakers can reach for when currency intervention and fiscal conservatism aren't likely or available.

It won't be different this time

Market forces and policy action argue for gradual dollar weakening against our major trading partners. We believe the Trump administration would like to see an orderly decline in the value of the dollar that at least partially reverses the 20–50% strengthening that had occurred since 2014 (Fig. 6, next page). We believe this to be the case because, as discussed, (1) a weaker dollar is a natural economic reaction to a large trade deficit, and (2) there are specific policy actions being taken that appear designed to make US markets less attractive to foreign capital.

[1] Nikolaos Panigirtzoglou, et al, "Flows and Liquidity: Gauging capital flow taxes," J.P. Morgan, June 2025.

Fig. 6: US dollar strengthening against top 5 trading partners, 2013–June 2025



Source: Bloomberg, Mill Creek.

The other deficit

While Washington is primarily focused on our trade deficit, we're equally concerned with the mid-term implications of US fiscal policy as the proposed One Big Beautiful Bill will push annual deficits to $4 trillion within a decade.

Our national debt is approaching $37tr. Approximately 21%, or $7.6tr, has to be refinanced over the next 12 months. Once we add an additional $2tr of new deficit spending to that total, the US Treasury is responsible for placing nearly $10tr of Treasury debt into the market per year. As Nora Pickens discusses in "Treasury Issuance: Can't Stop, Won't Stop," we could be pushing the limits of what the global market can digest.

> *When a country isn't saving enough to fund its investments, and the government is also spending more than it takes in, the country has to cover the gap by borrowing from abroad.*

While many economic factors, including inflation and economic growth, impact interest rates, we should also be cognizant that, on the margin, voluntary buyers' long-term US Treasury debt (e.g., wealthy individuals in the US and abroad, domestic and foreign insurance companies, etc.) may become less willing to lend at reasonable yields. This outcome could push yields higher even as the dollar declines.

Positioning

Our general portfolio positioning can be described as neutral equities, underweight fixed income, and overweight alternative income (e.g., private credit, core real estate, farmland). A detailed summary can be found on p. 5. We also believe current market conditions create a good opportunity for certain private real estate strategies, one of which Sam McFall examines on p. 9.

Within equities our target portfolios are neutral to the US versus international and have an underweight in the still-frothy large-cap part of the US market. However, many taxable investors are finding it difficult to rebalance due to the substantial outperformance of US large-cap over the last 10–15 years. Mike LoCasale discusses options investors have for managing low-basis positions on p. 11.

Practical Applications: International Equities

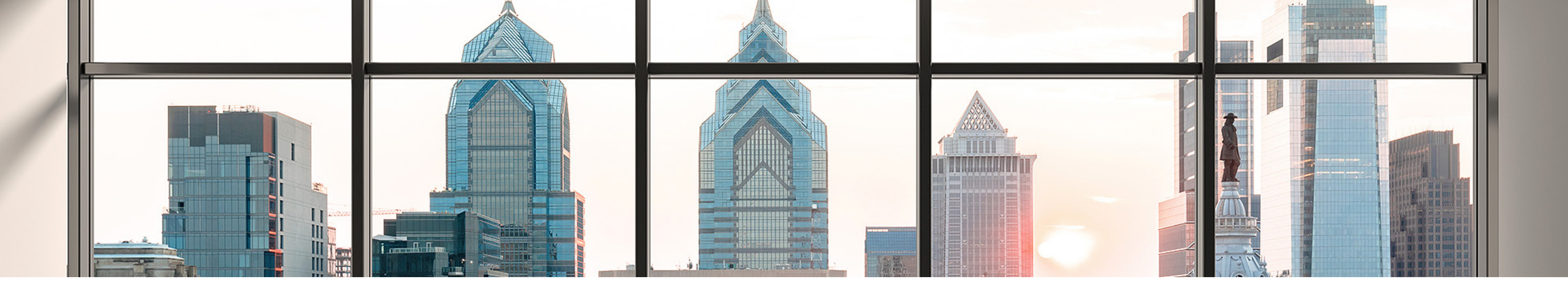
The impact of currency movements on portfolio returns can be perplexing for many investors.

We hope this example is useful in clarifying how currency fluctuations impact investment returns:

> A US investor wants to invest $100 in the MSCI Europe Index. In order to buy European equities, the investor needs euros. One euro currently trades at 1.13 dollars, which means 1 dollar buys 0.88 euros. He converts 100 dollars to 88 euros and purchases the MSCI Europe Index. Then he waits a month and the MSCI Europe Index is trading at exactly the same level he purchased it at. He sells his position at a 0% gain and receives 88 euros. However, the dollar has fallen 10% against the euro which means 1 euro now buys 10% more dollars. The exchange rate is now 1.24 EUR/USD. He converts back to dollars and now has $110, or a 10% gain.

US investors don't literally execute the foreign exchange transactions described in the example — when you buy or sell an ETF or mutual fund, those transactions are done behind the scenes. However, the total return for a US investor will be the return of the underlying equity market plus the impact of the currency movement.

This year has been a good illustration of how currency movement can impact investor return. As of June 20, the MSCI Europe Index (EUR) is up 7.54%. That's the total return a euro-based investor has earned this year. A dollar-based investor has earned 19.1% by investing in the same index because they earn the total return of the index, plus the currency impact added another 11.5% to their return.



House View Summary

Our Tactical Preferences

	Underweight	Neutral	Overweight
Cash		=	
Municipal Fixed Income	–		
State/Local GO	–		
Lease			+
Transportation	–		
Higher Education		=	
Health Care			+
Duration		=	
Taxable Fixed Income	–		
Corporate			+
Government	–		
Securitized			+
Duration	–		
Public Equity		=	
US Large-Cap	–		
US Mid- and Small-Cap			+
US Growth		=	
US Value		=	
International Developed		=	
Emerging Markets		=	
Private Assets			+
Private Debt			+
Private Equity			+
Private Real Estate			+

Our Perspective

1. Policy uncertainty continues to weigh on the US economy, but consumer sentiment has stabilized.
2. US economic growth remains solid. Aggregate income growth remains above 4% and we haven't seen a deterioration in two of the best leading indicators — residential investment and heavy truck sales.
3. The Fed's "transitory" inflation fight has finally come to an end. We expect the Fed to cut rates one or two times before the end of 2025.
4. Within fixed income, we are neutral duration and believe it is prudent to maintain high credit quality. We are also underweight fixed income in favor of alternative income strategies like private credit.
5. US equity valuations, particularly in the mega-cap growth space, remain elevated. International and US small-cap are more reasonably valued.
6. The correlation between stocks and bonds remains high, making diversifiers increasingly important.
7. We are overweight private equity and private real estate versus the rest of the portfolio.

Second Quarter 2025: Market Review

- Trade news remained front and center in Q2, with the White House's "Liberation Day" announcement on April 2 causing significant volatility throughout the capital markets over the early weeks of the quarter.
- Despite this volatility, global equities ended the quarter significantly positive, with most major indexes posting double-digit returns in USD terms. This performance was largely due to a number of perceived positive developments on the trade front throughout the quarter, as well as strong corporate performance results from Q1.
- Fixed income returns were muted, with investment-grade taxable and tax-exempt bonds roughly flat in Q2. Interest rates were quite volatile during the quarter as investors attempted to assess the potential impact of the trade conflict on the global economy.
- US economic growth is expected to slow in Q2 and for 2025 overall, with consensus estimates projecting GDP growth of roughly 1.5% for both this quarter and this year as a whole.
- Personal Consumption Expenditures (PCE) inflation has remained steady over recent months, at roughly 2.3% year-over-year.
- The labor market remains on solid footing, with the most recent unemployment rate of 4.2% largely unchanged since last quarter.
- The Federal Reserve kept its policy rate steady at a range of 4.25–4.5%, citing the potential for the current trade conflict to work against both of its dual mandates (low unemployment and reasonable levels of inflation). The central bank expects to cut rates twice during the second half of 2025, while markets are pricing in three cuts.

Index Returns (as of June 30, 2025)	Q2 2025	YTD	2024	2023	2022	2021	1 Year	3 Years	5 Years	10 Years
Global Equities	11.5%	10.0%	17.5%	22.2%	-18.4%	18.5%	16.2%	17.3%	13.7%	10.0%
US Equities	11.0%	5.8%	23.8%	26.0%	-19.2%	25.7%	15.3%	19.1%	16.0%	13.0%
Large Cap US	11.1%	6.1%	24.5%	26.5%	-19.1%	26.5%	15.7%	19.6%	16.3%	13.4%
Mid Cap US	8.5%	4.8%	15.3%	17.2%	-17.3%	22.6%	15.2%	14.3%	13.1%	9.9%
Small Cap US	8.5%	-1.8%	11.5%	16.9%	-20.4%	14.8%	7.7%	10.0%	10.0%	7.1%
US Growth	17.6%	5.8%	32.5%	41.2%	-29.0%	25.8%	16.9%	25.1%	17.5%	16.4%
US Value	3.8%	5.5%	14.0%	11.7%	-8.0%	25.4%	13.3%	12.5%	13.9%	9.0%
Int'l Developed Equities	11.8%	19.4%	3.8%	18.2%	-14.5%	11.3%	17.7%	16.0%	11.2%	6.5%
Emerging Market Equities	12.0%	15.3%	7.5%	9.8%	-20.1%	-2.5%	15.3%	9.7%	6.8%	4.8%
US Taxable Bond Market	1.2%	4.0%	1.3%	5.5%	-13.0%	-1.5%	6.1%	2.5%	-0.7%	1.8%
US Municipal Bond Market	1.0%	1.7%	0.9%	4.6%	-4.8%	0.5%	3.5%	2.7%	1.0%	2.0%
Diversified Commodities	-3.1%	5.5%	5.4%	-7.9%	16.1%	27.1%	5.8%	0.1%	12.7%	2.0%
Hedge Funds	2.5%	1.8%	11.1%	7.8%	-6.9%	9.7%	5.9%	7.1%	7.1%	4.4%

Private Asset Index Returns (as of December 31, 2024)	2024	2023	2022	2021	2020	1 Year	3 Years	5 Years	10 Years
Global Equities	17.5%	22.2%	-18.4%	18.5%	16.3%	17.5%	5.4%	10.1%	9.2%
Private Equity	7.5%	8.2%	-0.3%	36.1%	20.3%	7.5%	5.1%	13.7%	13.6%
US Taxable Bond Market	1.3%	5.5%	-13.0%	-1.5%	7.5%	1.3%	-2.4%	-0.3%	1.3%
Private Credit	9.7%	8.6%	1.4%	18.2%	2.8%	9.7%	6.5%	8.0%	7.4%

Key Rates (as of stated date)	Jun-2025	Dec-2024	Dec-2023	Dec-2022	Dec-2021	Dec-2020	Dec-2018	Dec-2017	Dec-2016	Dec-2015
US 10-Year Treasury	4.2%	4.6%	3.9%	3.9%	1.5%	0.9%	2.7%	2.4%	2.4%	2.3%
Barclays Aggregate Bond Index	4.5%	4.9%	4.5%	4.7%	1.8%	1.1%	3.3%	2.7%	2.6%	2.6%
BBarc Muni 1-10 Yr Blend (1-12) Index	3.3%	3.4%	2.8%	3.0%	0.7%	0.6%	2.2%	2.0%	2.1%	1.6%

Source: Bloomberg, Mill Creek. Returns for periods greater than one year are annualized. Index rates are yield to worst. As of 06/30/2025 unless otherwside stated.

Indices used to represent periodic capital markets returns include: MSCI ACWI (Global equities), Russell 3000 (US equities), Russell 1000 (Large Cap US), Russell Mid Cap US (Mid Cap US), Russell 2000 (Small Cap US), Russell 3000 Growth (US Growth), Russell 3000 Value (US Value), MSCI EAFE (International Developed), MSCI Emerging Markets Index (Emerging Markets Equities), Bloomberg Aggregate Bond Index (US Taxable Bonds), Bloomberg 1–10 Year Municipal Bond Index (US Municipal Bonds), HFRX Global Hedge Fund Index (Hedge Funds), Bloomberg Commodity Index TR (Diversified Commodities), Bloomberg Buyout PE Index (Private Equity), and Bloomberg Private Debt Index (Private Credit).

The historical index performance results are provided exclusively for comparison purposes over various time periods only. It is not possible to invest directly in an index. Index performance does not reflect any management fees, transaction costs, or other expenses that would be incurred by a portfolio or fund, or transactions in fund shares. Such fees, expenses, and commissions would reduce returns. It should not be assumed that any account holdings will correspond directly to any comparative index reflected herein. Data as of June 30, 2025.

Treasury Issuance: Can't Stop, Won't Stop

By Nora Pickens, Partner, Investment Strategy

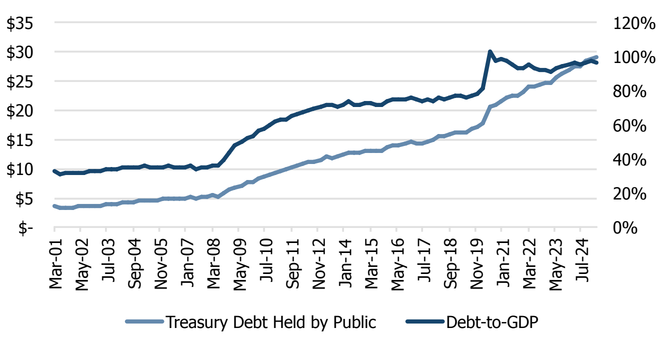
As Michael Crook highlighted in his opening commentary, the United States is entering a period in which the Treasury will have to refinance an unprecedented volume of maturing debt while funding persistently large budget deficits. Below we explore the supply-demand dynamics shaping this environment.

Supply: Where we stand today

As of May 2025, Treasury debt held by the public (excluding intragovernmental holdings) totals $29tr. This primarily consists of $6tr in Treasury bills (<1 year maturity), $15tr in notes (1-to-10-year maturity), $5tr in bonds (>10-year maturity). The weighted average interest rate is 3.4%, and the average maturity is 71 months — fairly typical by historical standards. Since 2000, the average yield has hovered around 3.5%, with maturities averaging 5 years and T-bills typically comprising about 20% of the debt mix.

What is unusual, however, is the sheer amount of debt. At just under 100% of debt-to-GDP, it is near all-time highs for non-recessionary periods (Fig. 1). That magnitude, combined with an expansionary fiscal stance and a higher-for-longer interest rate regime, makes today's supply dynamics uniquely challenging.

Fig. 1: Treasury debt outstanding ($T) vs. debt-to-GDP

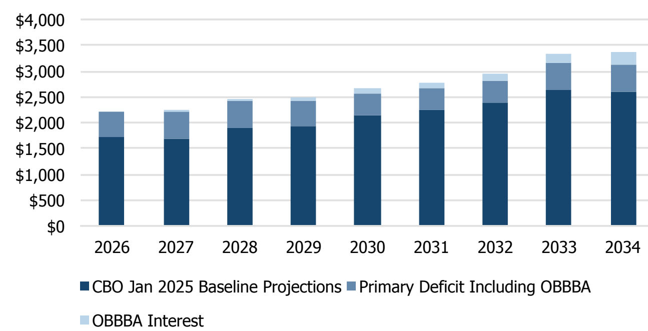


Source: Bloomberg, Mill Creek, as of 5/31/25.

Forward-looking issuance and interest burden

The Congressional Budget Office's latest projections — which incorporate the One Big Beautiful Bill Act (OBBBA) and assume various temporary provisions are made permanent — forecast a federal deficit of $1.7tr in 2025, with annual deficits averaging $2.5tr through 2034. On this trajectory, gross federal debt rises to $54tr by 2034, or a 129% ratio of debt-to-GDP (Fig. 2). To meet its financing needs, the Treasury will need to issue more than $10tr annually, between refinancing existing debt and new deficits.

Fig. 2: Net interest cost ($B)



Source: CBO, Mill Creek.

Interest rates present a risk to the supply forecast. The CBO assumes a 4.1% yield on the 10-year Treasury in their forecast budget. But deviations of just +50 to +150 basis points could add $2–$5tr in cumulative interest expense between 2025 and 2034. Regardless of the exact path, interest payments are on track to become one of the government's largest and least flexible budget items — surpassing spending on major programs like Medicare and defense (Fig. 3, next page).

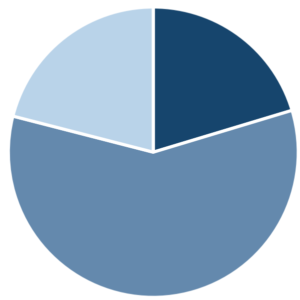
Who will buy all those bonds?

From 2008 to 2022, the Federal Reserve acted as the marginal buyer of Treasuries through successive rounds of quantitative easing. As a price-insensitive buyer, the Fed suppressed volatility and yields by absorbing supply for policy — not investment — reasons.

But that dynamic has changed.

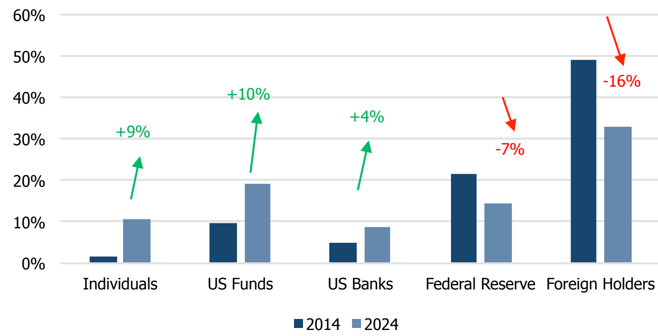
With the Fed no longer expanding its balance sheet, the marginal buyer has shifted to more price-sensitive investors — including foreign individuals, US households, and hedge funds — who are willing to step in but only at yields that compensate them for perceived risks at the time. We have

Fig. 3: Projected major federal budget expense items, 2034



Source: CBO, Mill Creek.

Fig. 4: Major holders of US Treasuries (% ownership of market)



Source: SIFMA, Mill Creek.

already observed term premiums (compensation required by investors to own longer-dated securities) move up over 100 basis points since 2020 partially in response to this new buyer pool.

Although foreign holders account for nearly 35% of outstanding Treasuries, their appetite has slowed. Over the past decade, foreign investors decreased their share of Treasury holdings by 16 percentage points (Fig. 4). In their place, domestic buyers, namely wealthy individuals and investment funds (mutual funds, ETFs, money markets, etc.), have stepped in to fill the gap. Assuming current trends persist, these US-based, non-Fed investors will need to absorb around $3tr of net new issuance annually.

This is achievable in the context of the $200tr in total financial assets held by US investors, but it means the composition of balance sheets will change to make room for rising government debt issuance. For instance, to absorb the additional supply, domestic entities need to increase their annual Treasury purchases by 20–25%. If US Pensions, who currently own 3.5% of the Treasury market, were to increase their holdings by 25% in 2026, it would raise their total financial asset balance sheet exposure to just under 5%. US households are also likely candidates to increase their buying and have a more sizable impact. A 25% increase would equate to $670bn of new demand, increasing Treasury holdings to 2.6% of their total financial assets, all else being equal.

Another source of new demand could stem from regulatory reforms aimed at US banks: specifically, the potential exclusion of US Treasuries from the Fed's supplementary leverage ratio (SLR) calculation. Today, the SLR requires US banks with more than $250bn in assets to hold capital equal to at least 5% of their assets. By excluding Treasuries in their asset count, it would likely increase demand for Treasuries by banks since they no longer need to reserve capital against those holdings.

Either way, assuming foreign holders remain bearish on Treasuries and the Federal Reserve does not step in, the allocation to Treasuries on domestic investors' balance sheets across the board is set to increase as new issuance ramps up. This not only places an upward pressure on yields but also crowds out other investments which are more growth oriented.

What happens next?

Over the longer term, if fiscal conditions remain unchanged, it is likely rates will move higher. Should market functioning deteriorate significantly, the Fed may eventually need to reenter the market with unconventional tools — including large-scale asset purchases or yield curve control à la the Bank of Japan. Ultimately, we're stuck between a rock and a hard place until policymakers commit to long-term fiscal reforms that align spending with revenues.

In summary:

- **Supply growth is structural:** Refinancing alone requires trillions of dollars in auctions every year, before a single new deficit dollar is funded.
- **Small rate moves matter:** A modest 50 basis point increase in long rates costs nearly $2tr over a decade.
- **The marginal buyer now needs convincing:** With the Fed and foreign buyers on the sidelines, private investors — more sensitive to risk — determine clearing yields.
- **Higher interest rates can persist:** Absent meaningful fiscal reform or renewed Fed intervention, 4–5% on the 10-year looks like the new normal.

Investing in Manufactured Housing Can Deliver Financial and Social Value

By Sam McFall, Managing Director, Investment Strategy

While there is a significant housing shortage in the US of approximately 2.4 million homes, the supply problem is even more acute for lower-income households. Affordability issues related to higher home prices as well as higher mortgage rates are keeping existing homeowners in place and driving potential buyers to the rental market. For low-income households, affordable housing options are typically found in multifamily apartments, single-family rentals (SFR), or manufactured housing, as these households are priced out of the single-family for-sale market.

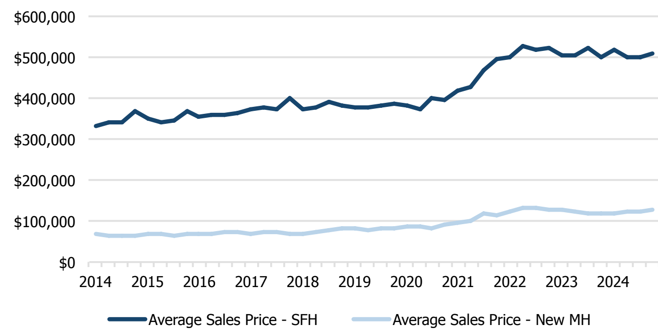
Fig. 1: Rental housing options

	Manufactured Housing	Single-Family Rentals	5+ Unit Apartments
Size of the market	7 million homes	14 million homes	21 million apartments
Property ownership	Highly fragmented	Largely institutional	Largely institutional
Unit size	1,400 sq ft	1,800 sq ft	1,000 sq ft
Tenant turnover	10–20%	25–35%	40–50%
Projected rent increases	4–4.5%	4.5–5%	2.5–3%

Sources: Green Street, Proteus MHP, Mill Creek, March 2025.

Manufactured housing directly addresses the unmet demand for affordable housing as it offers a significant price discount (~75%) to single-family home ownership as well as other rental options like SFR and apartments (Fig. 2). Despite its promise as a solution to the affordable housing shortage, there has been limited development of new communities over the last two decades due to restrictive zoning, strict regulations, and "not-in-my-backyard" (NIMBY) resistance from neighbors. There are roughly 45,000 manufactured housing communities in the United States today, and the vast majority (~75%) are owned by "mom and pop" investors. In many cases, poor management has limited a property's potential in creating both financial and social value. While the return potential is undoubtedly attractive, it is not without accepting additional risks such as regulatory red tape, higher rate of foreclosures in an economic downturn, or even the total loss of the property due to natural disaster just to name a few.

Fig. 2: Average sales price — single-family homes (SFH) vs. new manufactured homes (MH)



Sources: Federal Reserve Economic Data (FRED), Equity LifeStyle Properties, Mill Creek, December 2024.

According to the US Department of Housing and Urban Development (HUD), more than 22 million Americans live in manufactured homes. These homes account for about 7% of total occupied housing stock and, in rural areas, represent an even larger share, comprising 15% of occupied housing. Manufactured housing is the largest source of unsubsidized affordable housing in the United States. Without government support and virtually no new supply, there is a compelling case for value-add real estate investors to acquire, improve, and stabilize these properties through either a home rental or land-lease strategy.

In a home rental strategy, the landlord owns the land, community infrastructure, and the homes. While this business model can be attractive at scale, it is inherently riskier with higher tenant turnover, higher eviction rates, lower rent collections, and higher capital expenditures. Meanwhile, in a land-lease strategy, the property owner owns the land, streets, utilities, and all common area amenities, and they simply lease the individual pad sites to homeowners. This business model tends to be less risky due to the durability of cash flows as tenants stay for longer, often 10+ years, due to the prohibitive expense of relocating homes (estimated at $6,000–$10,000 per Sun Communities, Inc.). Additionally, residents are responsible for all home-related capital expenditures, and rent growth typically increases faster than inflation.

Value-add investors are looking to institutionalize the sector by acquiring existing properties where an infusion of fresh capital can materially improve these communities in addition to generating stronger financial performance. Simple cosmetic fixes such as repaving roads, updating landscaping, and adding amenities go a long way in creating a sense of community where the homeowners take pride in being part of the neighborhood.

Value-add investors are looking to institutionalize the sector by acquiring existing properties where an infusion of fresh capital can materially improve these communities in addition to generating stronger financial performance. Simple cosmetic fixes such as repaving roads, updating landscaping, and adding amenities go a long way in creating a sense of community where the homeowners take pride in being part of the neighborhood. Other improvements that can enhance financial performance include optimizing utility recapture methods, transitioning residents to automatic rent payments, and increasing occupancy through direct home sales or lease-to-own contracts.

In a recent residential sector report produced by Green Street, the manufactured housing sector was highlighted as having the highest expected private market returns on an unlevered basis due to strong and improving fundamentals. The potential to generate an attractive return while also helping to address a shortage of affordable housing makes an investment in the manufactured housing sector worth pursuing.

Approaches to Managing Low-basis Positions

By Michael LoCasale, Director, Investment Strategy

Low-basis positions create unique challenges for the efficient management of taxable portfolios. Inherently, these positions are costly to exit, as their embedded capital gains can generate a significant tax liability upon liquidation. However, tax cost is only one aspect of the portfolio management calculus, and investors holding low-basis positions must balance the tax cost of selling a low-basis position with:

1. The expected return and potential drawdown risk from the low-basis position(s),

2. The expected benefits of diversification.

Given the tradeoffs, what is the best way to approach managing low-basis positions? The answer largely depends on a number of investor-specific variables, including time horizon, aversion to fees/taxes, and comfort with complexity. Below, we provide a survey of a handful of options for managing low-basis exposures.

Tracking error explained

From an investment perspective, low-basis positions can negatively impact appropriate portfolio implementation. This impact largely revolves around the concept of "tracking error."

Simply put, tracking error is a measure of how the performance of an investment differs from that of its benchmark over time. It is an important concept in portfolio management, as tracking error causes an allocation's actual risk to deviate from its intended risk. In general, the more concentrated a position, the greater the potential for increased tracking error. This applies not only to individual stock positions, but also to "focused" exposures more broadly, including sector-/style-specific funds or actively managed strategies.

In addition to tracking error, if a reluctance to rebalance (reduce the position) due to embedded gains is causing an investor's overall portfolio to be overweight risk assets, their overall asset base runs the risk of exhibiting more volatility than is appropriate for their circumstances.

Do nothing

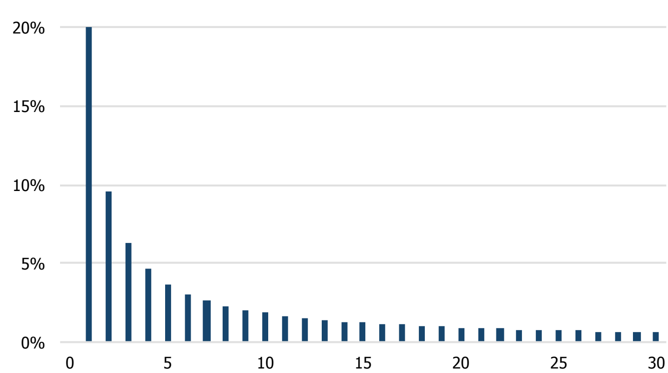
While it may seem counterintuitive, continuing to hold a low-basis position may be the best course of action in certain circumstances. If an investor anticipates a "step up" in basis in the near future, it may be hard to justify the tax cost of reducing the position prior to that event. Additionally, investors who expect material inflows to their portfolio (via cash or other assets) may be able to reduce the position's weight without selling via adding to other areas of the portfolio. Further, investors who are particularly averse to paying fees or realizing gains may opt for the potential costs associated with holding a low-basis position over the known costs of trimming the position.

Sell and pay taxes

The simple approach of selling a low-basis position, reallocating the proceeds, and paying the associated taxes is often prudent for an investor whose time horizon is sufficiently long to "recoup" the initial tax hit or who desires a lower-risk portfolio. Logically, the longer the time horizon, the lower the annual outperformance that is needed for the "new" asset to pay off the tax liability from selling the low-basis position (Fig. 1).

Investors may also choose to exit their position over a number of years so as to spread out the associated tax liability from a cash-flow perspective. This approach can also help ensure an investor's realized capital gains do not exceed certain thresholds and push them into a higher tax bracket.

Fig. 1: Annual outperformance needed to overcome 20% tax liability



Source: Mill Creek.

To get a sense for the effectiveness of this approach, it can be helpful to frame the tax impact from selling the position relative to the consequent reduction in drawdown risk. If reducing the position is expected to result in materially less drawdown risk moving forward, this may justify the cost of realizing the associated capital gains.

Long-only direct indexing

To help mitigate the tax impact of reducing exposure to a highly appreciated position — and to further control for tracking error during the process — investors may choose to implement complementary strategies alongside selling the security. One such strategy is long-only direct indexing, which can be used to generate capital losses to offset a portion of the investor's tax liability, as well as to diversify against the risk of the position.

At a very high level, long-only direct indexing uses optimization software to track the performance of a benchmark (typically a major equity market index) by holding a subset of the benchmark's underlying companies within a separately managed account (SMA). Over time, the strategy will sell positions that are trading at a loss, replacing them with another security with similar characteristics.

Within the context of managing low-basis positions, in certain cases an investor could opt to contribute the position to a direct-indexing SMA. The direct-indexing manager would then optimize the account's remaining assets to best diversify against the position-specific risk (relative to the account's benchmark), while utilizing the losses generated within the account to trim the position in a more tax-efficient manner over time.

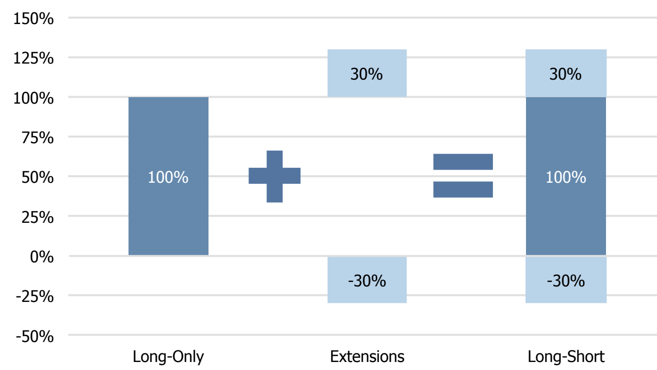
Long-only direct-indexing accounts typically have low management fees and reasonable minimums, and as such represent an easily accessible complement to include in portfolios when reducing low-basis positions.

Long/short direct indexing

An extension of long-only direct indexing, long/short direct indexing is a more sophisticated strategy that can be utilized to complement reducing exposure to a low-basis position. Conceptually, long/short direct indexing builds on long-only direct indexing by implementing long and short extensions on top of the initial "100% long" exposure (Fig. 2). As an example, one of the commonly seen iterations of this strategy is "130/30," whereby long and short extensions of 30% are implemented such that the account has 130% long exposure and 30% short exposure. Comparatively, long-only direct indexing can be thought of as "100/0," having 100% long exposure and 0% short exposure.

Given the "net" exposure (long exposure minus short exposure) of the long/short direct-indexing strategy is identical to

Fig. 2: Long-only direct indexing vs. long/short direct indexing



Source: Mill Creek.

that of the long-only strategy, the two should be expected to perform in a very similar manner. However, long/short direct indexing has the potential to generate greater tax benefits due to its extensions. Inherently, the account's short exposure will perform inversely to its long exposure, aiming to create more opportunities to harvest losses (both in terms of magnitude and consistency). The strategy's added "gross" exposure (via the long and short extensions) can also be optimized to further reduce the account's tracking error and provide diversification.

The potential benefits of long/short direct indexing do not come without drawbacks, however. Given the complexity of the strategy, it involves higher costs compared to the other approaches mentioned in this piece, both in terms of management fees and borrowing costs associated with the strategy's leverage. Further, should the strategy's leverage need to be unwound in short order — for reasons including unexpected cash needs, a desire to exit the markets immediately, or the death of the account holder — there is likely to be a significant cost associated with closing out the portfolio's positions (in many cases negating the additional tax benefits generated up until that point).

Investors should weigh the potential benefits of long/short direct indexing against its costs, in addition to their degree of comfort with leverage and complexity.

Charitable giving

For investors who are charitably inclined, low-basis positions represent ideal gifting candidates. Donating highly appreciated securities allows for a reduction in exposure without a taxable event — in fact, the investor may even receive an income tax deduction for the charitable donation (up to applicable limits).

Investors should look to incorporate asset selection into their philanthropic efforts, and conversely, aim to utilize charitable giving as a portfolio management tool.

Shares can be donated to many organizations outright or contributed to an entity which is established to facilitate charitable giving. Two such structures that are commonly seen are donor-advised funds (DAFs) and charitable remainder trusts (CRTs). While an in-depth discussion of these structures is outside the scope of this piece, at a very high level, DAFs allow for immediate donations to a charitable account (and as such can be counted toward charitable deductions) with grants being made at a later date, while CRTs provide a lifetime income stream to beneficiaries while ultimately designating the remaining trust assets to a charitable beneficiary upon the passing of the last income beneficiary. Both structures allow for improved tax efficiency when rebalancing the highly appreciated position within the new entity, which can be used to diversify the assets.

Investors should look to incorporate asset selection into their philanthropic efforts, and conversely, aim to utilize charitable giving as a portfolio management tool.

Conclusion

While the above list is certainly not exhaustive, it represents methods which should be broadly applicable for most investors aiming to manage out of highly appreciated holdings. Such approaches can be further refined to incorporate more portfolio-specific solutions, such as options strategies, where appropriate, based on individual investor circumstances.

At the end of the day, managing an investment portfolio is largely a balancing act. In the case of low-basis positions, the tax liability associated with realizing capital gains can be painful, but investors should also ensure the tax “tail” isn’t wagging the investment “dog.” When properly implemented in portfolios, the described approaches should help soften the tradeoffs between the two.

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