The Sizemore Income Letter

April 2020

A Brave New World

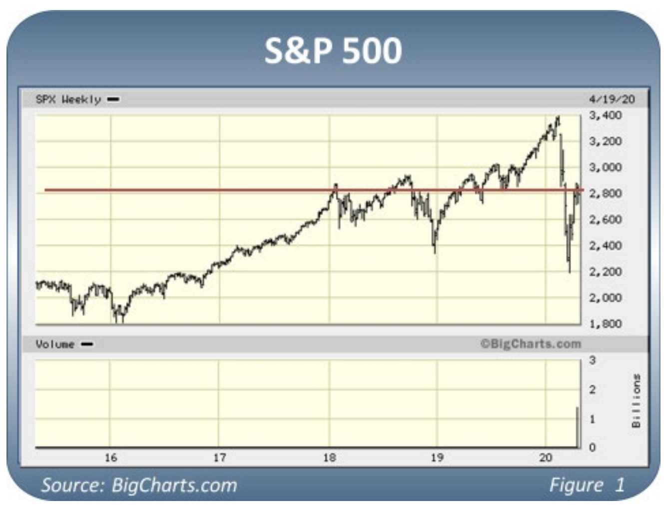
By Charles Lewis Sizemore, CFA

Greetings from the ranch!

Many of you haven't heard from me in over a month, and we have a lot to catch up on.

This time last month, lockdowns were starting across most of America. Today, they continue… though several states are at least starting to talk about reopening. That's an encouraging step in the right direction.

Alas, my status hasn't changed. I was in Lima, Peru with my wife and kids when all hell started to break loose. We suspected the government was about to put a curfew into effect, but we had no idea what the details would be or long it might be in effect. We just knew we didn't want to be stuck in a tiny urban apartment when it happened.



Source: BigCharts.com Figure 1

So, we drove nine hours up the road to my father in law's ranch… where we've been camped out ever since. I haven't left the ranch in five weeks, and if I tried I'd have nowhere to go. Nothing is open. Anywhere. And the highway to the nearest major city is road-blocked by the army.

I can tell you I'm ready to get the hell out of here. And I would… if there was a functioning airport.

I have fantastic inlaws, but five weeks (and counting) is an awfully long time to be sharing a house with them. The U.S. embassy knows I'm here… and they're working on authorizing rescue flights. But it might still be a while.

I'm looking forward to sitting in my house in Dallas again, and I can almost taste the Whataburger. But for now, we have business to attend to.

I won't bore you with a lengthy recap of what happen over the past two months. We had an epic stock market collapse followed by a nearly equally epic rally that clawed back about half of the losses.

I'm a lot more interested in what happens next. And while I like to err on the side of bullishness, I think we need to be sober and realistic here.

To start, even though stock prices fell by over 35%, it's hard to argue the market as a whole ever got truly *cheap*.

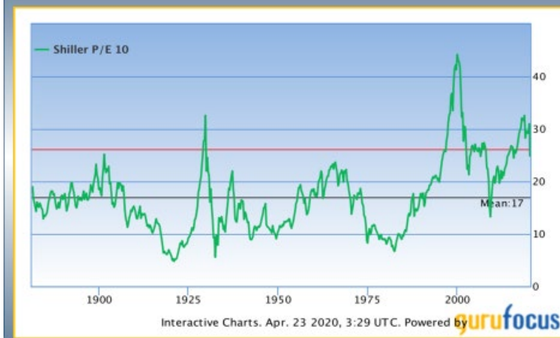
The declines took the S&P 500 back to late 2016 prices, essentially to where it was on election night. But remember, the 'Trump rally" started at a time when the U.S. market was already pretty pricey by historical standards. Stocks went from being expensive to being *more* expensive on the hopes of tax reforms and regulatory cuts.

Consider the cyclically-adjusted price/earnings ratio ("CAPE"), also known as the Shiller P/E after Yale professor Robert Shiller.

The Shiller P/E compares stock prices today to a 10-year average of earnings. This smooths out the effects of the economic cycle and helps to give us a better idea of the trend.

At their lowest point, stocks never really got all that cheap. Using history as a guide, a Shiller P/E at today's level of 26 implies that the S&P 500 is priced to deliver compound annualized returns of about 0.6% over the next eight years.

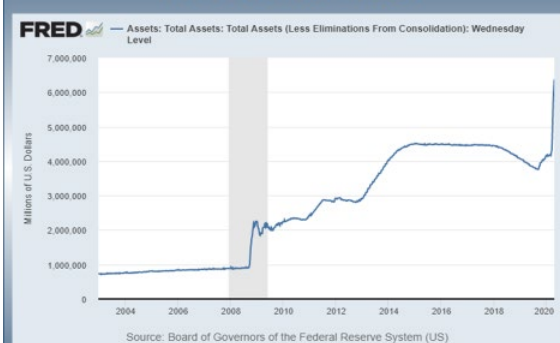
Shiller P/E Ratio



Source: GuruFocus.com *Figure 2*

Now, I'd take those numbers with a healthy grain of salt. Bond yields are much lower today than at any other time in history, and the Federal Reserve has all but promised to backstop *everything*.

Fed Balance Sheet



Source: St. Louis Fed *Figure 3*

The Fed has already increased its balance sheet by half, and this isn't over yet. As we saw after the 2008 meltdown, the Fed continued to pump liquidity into the system *years* after the crisis had ended. It wasn't until the end of 2013 that the possibility of tapering the "QE Infinity" bond-buying program was seriously discussed.

All this monetary stimulus may or may not help Main Street. That's still really debatable. But it should keep the stock market from sinking too far.

I'm not expecting a strong, durable bull market. I think the best we can hope for here is a sideways market that trades in a range for a while.

But that's not necessarily bad for us. Given our income focus, we can do really well in a sideways market.

Revisiting the 10 Stocks to Hold for the Rest of Your Life

Stock	Ticker	Entry Date	Buy Price	Recent Price	Stop Loss	Yield	Cumulative Dividends	Total Return	IRA Friendly?
Altria Group	MO	3/19/2020	$ 37.10	$ 37.81	None	8.90%	$ 0.84	4.18%	Yes
Realty Income	O	3/19/2020	$ 48.08	$ 50.18	None	5.61%	$ 0.23	4.85%	Yes
AT&T	T	3/19/2020	$ 31.15	$ 29.47	None	6.96%	$ 0.52	-3.72%	Yes
Enterprise Products Partners	EPD	3/19/2020	$ 14.52	$ 16.28	None	11.39%	$ -	12.12%	No
Kinder Morgan	KMI	3/19/2020	$ 11.20	$ 14.67	None	6.92%	$ -	30.98%	Yes
Ventas	VTR	3/19/2020	$ 19.98	$ 27.81	None	11.35%	$ 0.79	43.16%	Yes
Public Storage	PSA	3/19/2020	$187.60	$ 193.10	None	4.19%	$ -	2.93%	Yes
International Paper	IP	3/19/2020	$ 30.13	$ 29.97	None	6.81%	$ -	-0.53%	Yes
STAG Industrial	STAG	3/19/2020	$ 21.71	$ 24.94	None	5.76%	$ 0.12	15.43%	Yes
Retail Opportunity Investments	ROIC	3/19/2020	$ 7.25	$ 7.61	None	10.31%	$ -	4.97%	Yes
Average						**7.82%**			

If you read the last issue of my previous newsletter, you might remember that we got stopped out of everything during the March selloff. But I didn't want you to sit in cash and miss what I believed could be an epic rebound in high-quality income names. So, I put together a list of **"10 Stocks to Hold for the Rest of Your Life."**

My goal was to put together a list of high-quality dividend payers that would come out of this crisis stronger than ever. I wanted these to be stocks you could buy, drop in a drawer and forget about for years or even decades.

A month has passed. Let's see how that "forever" portfolio is holding up.

Perhaps not surprisingly, the most beaten-down stocks on the list have enjoyed the quickest recoveries. Senior living REIT **Ventas (VTR)** is up a whopping 43% including dividends paid. Yet even after a run like that, the stock is still 62% below its 52-week highs and still yields an incredible 11.4%.

The selloff in Ventas wasn't entirely irrational, though it was definitely overdone. The company's primary business is renting out senior living properties, and the Covid-19 pandemic has made a lot of would-be tenants think twice about moving in.

The last major announcement from the company was from March 17, when they announced that they had received "substantially all rent payments" year to date. But we have no idea what rent collection looked like in April or how bad things might look six months from now if the virus comes back in the next flu season.

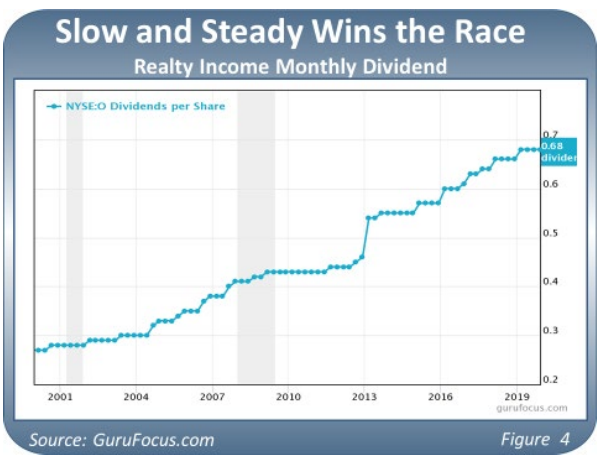
I think it's also too early to fully rule out a dividend reduction. But I'm perfectly

comfortable taking that risk because I expect any dividend reductions to be temporary.

Ventas is a best-in-class REIT backed by fantastic demographic trends in the aging of the Boomers, and Covid-19 doesn't change that. A selloff in the stock price was reasonable, but a selloff of the magnitude we saw certainly was not. The REIT was priced as if it were going out of business, and that was never a legitimate risk.

The other REITs on the list have also done fairly well. **STAG Industrial (STAG)** is up a little over 15%, **Realty Income (O)** and **Retail Opportunity Investments (ROIC)** are up about 5% and **Public Storage (PSA)**, is up about 3%.

I still consider all of these buys at current prices. But if you have limited capital to deploy at the moment, I'd suggest looking at Realty Income first.



This isn't hypothetical for me. I bought 288 shares of Realty Income over the course of 2009 that I swore to myself I'd never sell. I wanted to buy more, but coming out of the 2008 meltdown I didn't have a lot of capital to deploy. But I knew it was a stock I wanted to own for the long haul, and I instructed my broker to reinvest all dividends.

I haven't touched the shares in over a decade, but due to the magic of dividend reinvestment I now have 465 shares. The recent cratering of the share price actually helps me, as it allows my reinvested dividends to buy more shares at a discounted price.

Someday, when I'm old and gray, I'll turn off the dividend reinvestment. But by then, I'll likely have thousands of shares, and the monthly dividends being thrown off will likely be enough to cover a lot of my day-to-day expenses.

Realty Income is a retail REIT with some exposure to movie theaters, restaurants and other at-risk sectors. But it has the financial strength to make it through whatever comes next. If some portion of its rent roll doesn't get paid for a quarter or two, the company will be just fine.

Moving on, we've also gotten a nice bump in our pipeline stocks. **Enterprise Products Partners (EPD)** and **Kinder Morgan (KMI)** are up 12% and 31%, respectively.

The performance difference in these two is striking.

Their businesses are very similar – both are pipeline and logistics companies primarily concerned with moving natural gas – but the company structure is different. Kinder Morgan is a regular, good-old-fashioned corporation, whereas Enterprise Products is a master limited partnership (MLP).

That may seem like a distinction without a difference, but today it matters. Many institutional investors are prohibited from buying MLPs like Enterprise Products, but they have no restrictions on corporations like Kinder Morgan.

This creates opportunities for nimbler individual investors like us. If Enterprise is cheaper and offers a better yield, we can hold it indefinitely, collecting the distributions along the way. And if the company decides to reorganize as a corporation at some point in the future, we'll likely get a big capital gains bump.

In the meantime, we can simply hold both and collect the cash. (Note that Enterprise Products should not be held in an IRA).

The laggards of the group are the plain-Jane dividend stocks **AT&T (T)**, **Altria (MO)** and **International Paper (IP)**. Altria is up a modest 4% and AT&T and International Paper are down slightly. All are still trading at excellent prices.

How to Trade the "Forever Portfolio"

By definition, this is a long-term portfolio that requires essentially no maintenance. As such, I won't necessarily revisit this portfolio every month. But we'll revisit it from time to time or as market conditions warrant.

If you are still a couple years away from retirement, I recommend you instruct your broker to reinvest the dividends in additional shares. These are "hold forever" stocks, so dripping into new shares only increases your long-term income potential.

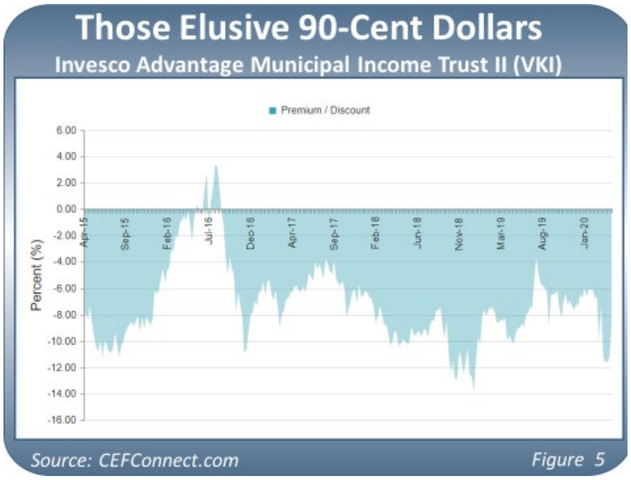
And if you are already retired or need the income, great! That's exactly what these stocks are for.

Moving On: The Sizemore Income Letter Portfolio

I'm also going to add two new income stocks that are currently on sale. These will be "normal" recommendations that I monitor every month.

The first is a good-old-fashioned tax-free municipal bond fund, the **Invesco Advantage Municipal Income Trust II (VKI)**. If you read my old newsletter, you know I'm a fan of closed-end funds (CEFs). Apart from the diversification and high yields, you also periodically get the ability to buy the funds at deep discounts to net asset value. Unlike mutual funds and ETFs, CEFs have not automatic mechanism to ensure that the share price actually matches the value of the underlying fund holdings. The number of shares is fixed, and the price fluctuates irrespective of what the underlying holdings are doing.

You can regularly buy a dollar's worth of quality bonds for 90 cents or even less when pricing gets out of whack.



Well, today we're not getting a 90-cent dollar. But we're getting awfully close. VKI trades at a discount of 8.36%, so we're getting its portfolio of muni bonds for a little less than 92 cents on the dollar.

Why I'm Bullish on Bonds

Outside of U.S. treasuries, most bonds dropped in value during March's market rout. But it wasn't credit quality that was the driver. It was liquidity, or more accurately the absence of liquidity. With the market in freefall and investors scrambling to raise cash, there were no buyers. The market quit functioning and prices dropped like a rock.

But then the Fed came along… Go back to that chart on page 2. That massive spike in the Fed's balance sheet represents a *lot* of bond buying. Most of it was treasury debt and mortgage bonds. But there was a fair bit of muni and corporate bond buying too.

Don't count on it stopping any time soon. The Fed didn't start pulling back on quantitative easing until 2013, five years after the 2008 meltdown had subsided. You see this round of quantitative easing ending faster?

I don't.

Eventually, all of this financial engineering by the Fed is likely to end badly. Over the long term, I don't see how it doesn't eventually ignite massive inflation and wholesale destruction of the dollar.

But the "long term" can be a long time coming. The Bank of Japan has been pushing the boundaries of what we all believed possible for a central bank for 30 years, and inflation is still nowhere to be seen in Japan.

So, I think it's safe to say we have time!

What Returns Should We Expect in VKI?

At current prices, VKI yields 5.01%, tax free. Let's translate that to tax-equivalent yields.

If you're in the 22% federal income tax bracket, that 5.01% tax free is equivalent to a 6.42% taxable yield. If you're in the 32% bracket, it's equivalent to a 7.37% taxable yield.

If you're in the 37% bracket… well, first of all, congratulations! You're clearly doing well in life. And your tax-equivalent yield would be a whopping 7.95%!

As the Fed continues to bid up the prices of bonds, I also expect us to see appreciation in the value of the portfolio. Between rising bond values and a shrinking of the discount to net asset value to a more "normal" level, I believe capital gains of 10% to 15% over the next year are very likely, and if investors flood So, total returns in the ballpark of 15% to 20% seem pretty reasonable, with the income portion of that being tax free. Not too shabby for bonds!

Action to take: Buy Invesco Advantage Municipal Income Trust II (VKI) at market. Set an initial stop loss at $9.58 based on closing prices.

BDCs On Sale

Virtually everything got slammed in March. But high-yield sectors like business development companies (BDCs) got hit particularly hard.

This isn't completely without merit. BDCs are about as close to Main Street as Wall Street gets. BDCs provide debt and equity financing to middle-market companies that are a too big for a bank loan but generally too small to effectively raise money in the stock or bond market.

Source: GuruFocus.com Figure 6

back into the sector in search of yield, the numbers could be a lot better than that.

Due to virus quarantines, many of these middle-market companies are cut off from their customers and have less access to bailout capital than the big boys. But when I see a sector that's lost nearly half its value, it's time to start sniffing around for value. And that brings me to my second recommendation, **Ares Capital Corporation (ARCC)**.

Source: GuruFocus.com Figure 7

Ares is the world's largest BDC with a market cap of nearly $5 billion and also one of the more conservatively allocated. 74% of its portfolio is invested in first and second-lien loans, meaning that Ares is first in line to get paid. Another 12% is invested in subordinated loans, and only 15% is allocated to equity.

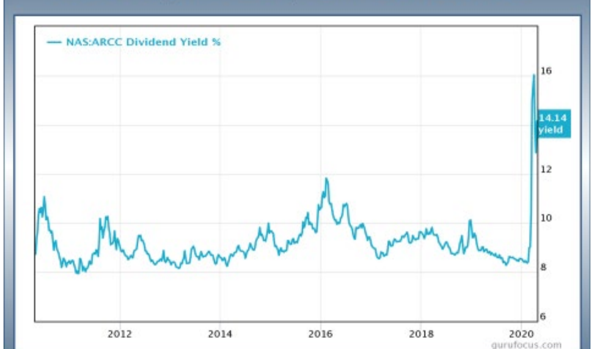
And importantly, the portfolio is largely free of the "problem" sectors. Only 3% is invested in energy, 2% in retail, and 2% in food and beverage.

Yet none of that seemed to matter in March. The shares dropped from a 2020 high of $19 all the way down to $7.90 before finally stabilizing above $11.

Today, Ares Capital trades for just 65% of book value. That means, hypothetically, you could buy up the entire company, sell it off for spare parts, and still walk away with a 35% profit, plus dividends earned along the way.

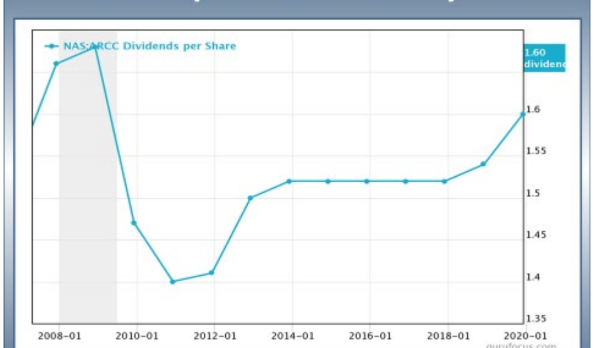
Now, obviously, that's not possible. And it's also entirely possible that book value may be overstated. Some of the holdings, particularly the equity holdings, might need to be written down slightly. But given the 35% discount to book value, I'd say we have a nice buffer. Ares usually trades right around book value, and I expect it will again soon enough.

Ares Capital Corp Dividend Yield



Source: GuruFocus.com *Figure 8*

Ares Capital Dividend Payout



Source: GuruFocus.com *Figure 9*

Meanwhile, the current dividend yield, at 14%, is enough to make your mouth water. There was only time in the entire history of the firm when the yield was higher, and that was during the pits of the 2008 meltdown.

That brings up the question of dividend safety. Ares did indeed reduce its dividend during the 2008 meltdown and aftermath. But it wasn't by a catastrophic amount. From the pre-crisis highs to the bottom, the total dividend cut was by 17%.

That's it.

Could the dividend get cut this time around? It's possible. Management has been coy about the dividend lately, and I think it's likely that they themselves are in wait-and-see mode. I suspect they're waiting to see how their portfolio companies perform over the next quarter before making any dividend decisions.

I don't expect them to make any reductions. But even if they do, I'm ok with that. We'd still be getting a deeply discounted portfolio managed by one of the best teams in the business. And as we saw during the last crisis, any dividend cut would likely be temporary.

Simply returning to book value would mean capital gains of over 50%. And in addition to that, we're getting a 14% yield. Assuming we hold this for two years, we could easily be looking at total returns of 75% to 100% and maybe more.

So, with no further ado…

Action to take: Buy Ares Capital Corporation (ARCC) at market. Set an initial stop loss at $9.69 based on closing prices.

That's going to wrap up this inaugural edition of the *Sizemore Income Letter*.

Until next time, keep cashing those dividend checks!

Charles Lewis Sizemore, CFA