# The Sizemore Income Letter

June 2021

## Inflation Proof Dividends

By Charles Lewis Sizemore, CFA

I'm never going to recommend Bitcoin in this newsletter.

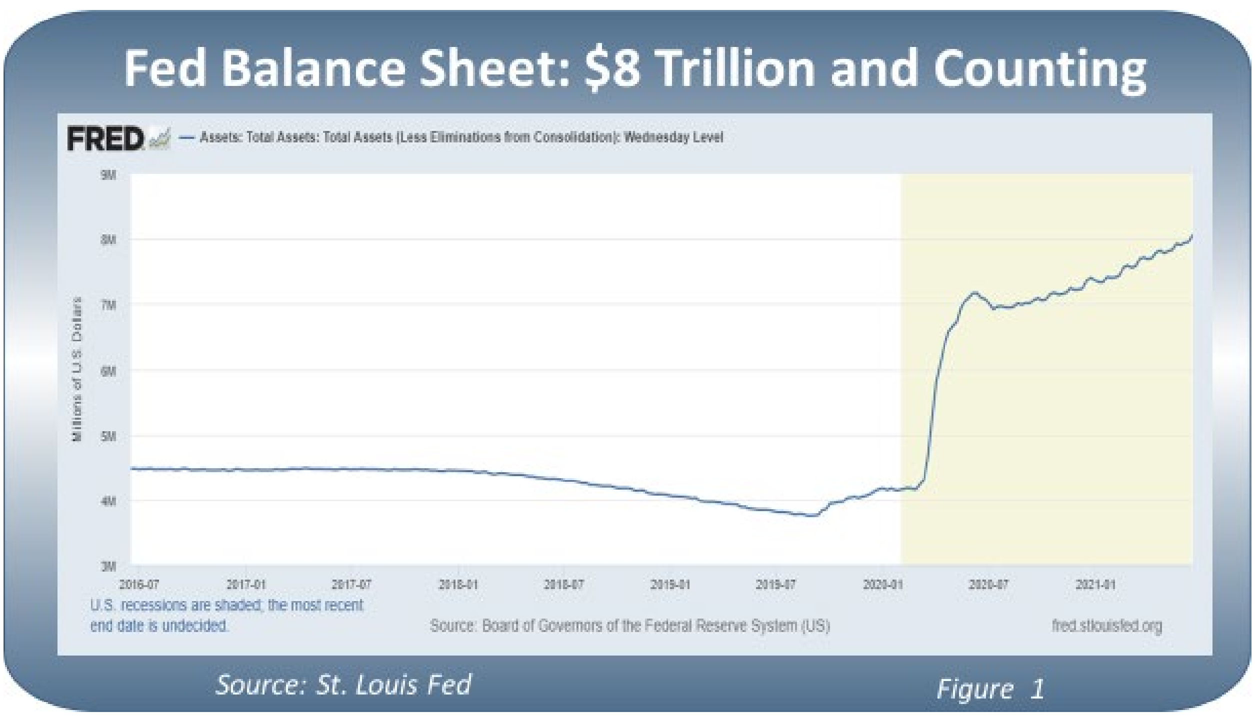
Nothing against it, of course. In fact, I own a little cryptocurrency myself, and I believe it makes sense to at least dabble in it.

But this is an *income* letter. My beat here is dividends, not cryptocurrencies. So unless we find a crypto play that pays dividends, you're not going to see it recommended here.

That said, the developments of the past few weeks are worth mentioning. For all the talk of the governments of the world being afraid of Bitcoin, El Salvador just made it official legal tender.

That's right. In the tiny central American country, you will soon be able to pay your taxes with Bitcoin. Businesses will be required to accept it. And as it is viewed as a currency rather than an investment, there are no capital gains taxes levied on it.

I don't want to give El Salvador more credit than it deserves. For most of the country's existence, it's been a poorly-run financial basket case.




Source: St. Louis Fed

Figure 1

But El Salvador's weaknesses have ironically become its strength.

As far back as 2001, the government punted on running its own currency. After decades of currency instability and runaway inflation, they decided to ditch the Salvadorian colon and replace it with the U.S. dollar. (Ecuador, Panama, and a smattering of smaller countries also use the U.S. dollar as their official currency.)

While the U.S. Federal Reserve is hardly a shining example of sound management, the dollar was still a vastly better option for El Salvador and brought the country a degree of financial stability it had never had before. Yes, the country is still a mess. But it likely would have been a lot worse had they not made the switch.

This comes back to my comment about weakness being strength. Because El Salvador was financially weak and unsophisticated, they had little to lose by ditching their currency and adopting the dollar. And today, it's the same story with Bitcoin. Why *not* use it? What do you have to lose?

In poorer countries, it's not particularly easy to open a bank account. An estimated 70% of Salvadorians don't have access to the traditional banking system and primarily use cash. They might as well live in a parallel universe to the one you and I live in.

But they also own smartphones. Yes, even working class people in Central America have smartphones now. And using them to make payments in crypto is a lot easier than trying to build out traditional banking infrastructure.

If you think that sounds crazy, consider that large swaths of the developing world skipped the landline phone and personal computer stages and went straight to smart phones. And with 5G wireless service eventually offering speeds comparable to high-speed wifi, there's really no reason to ever make the investments in the older telecom infrastructure.

I've seen it with my own eyes in Peru. My housekeeper has never – not once in her life – used a computer. She's never lived in a home with reliable enough electricity to power one, for crying out loud. But she has a functional Android smartphone that she uses to videochat with her family and do all the basic stuff you do with a smartphone.

Back to Bitcoin being adopted by El Salvador… This is likely just the beginning. Panama, Mexico, Colombia and Argentina are all reportedly considering making similar moves. And the more countries that accept cryptocurrencies, the more that will follow.

This is something I plan to keep an eye on. I have to believe that there will be some profitable income investments that will pop up.

But in the meantime, I want to get a little more fundamental. Identifying "why" Bitcoin and other crypto currencies have become popular is a long and complex story with a lot of parts. But one of those parts is fear of inflation stemming from central bank tinkering.

Fear of inflation is nothing new. Governments have been inflating fiat currencies for millennia, and investors have learned to deal with it in a number of ways.

Precious metals are an inflation hedge that has survived the test of time. People have stored at least part of their wealth in gold for most of human history.

But while gold has been a popular inflation hedge over the millennia, it wasn't always the best. Major new discoveries of gold – such as in the years following the Spanish conquest of the New World – created inflation just as nasty as today's central banks.

And this brings me to today's recommendation. To quote the comedian Will Rogers, *"Buy land. They ain't making any more of the stuff."*

I'm not recommending land, per se, but I am recommending real estate and for precisely for Will Roger's reasons. We live in an era in which a nearly unlimited supply of dollars is being thrown at a finite number of financial assets. All else equal, that's a recipe for rising prices.

Bonds are overpriced. Stocks are overpriced. Bitcoin *might* be overpriced. (I say "might" because no one really knows what a Bitcoin is worth and there still aren't any valuation models worth using.) Fine art is overpriced. Residential real estate is starting to look overpriced.

*Everything* is overpriced.

I agree with Harry Dent that all of this will end very badly. And I believe that the Fed will ultimately be what bursts this "everything bubble." We want to be prepared for that when it happens.

But I also think this may have a little longer to run. I take the Fed at their word when they say they're comfortable letting inflation run hot for a while, and that's exactly what I expect them to do.

And if inflation is going to run hot for a while, that's fantastic news for real estate investment trusts (REITs).

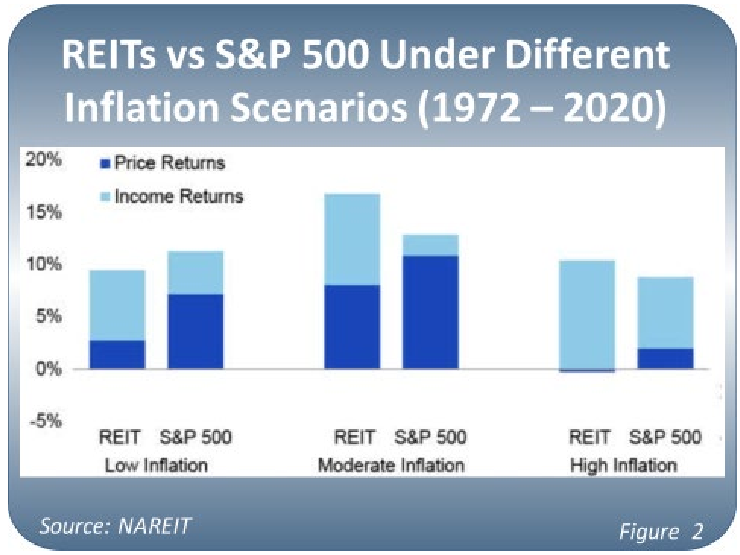



Figure 2

During periods of low inflation, stocks tend to outperform REITs. Bit during times of moderate or high inflation, REITs tend to dominate.

And beyond the inflation angle, REIT fundamentals are looking up. As a case in point, consider retail sales. They cratered during the pandemic, but they've come back strongly this year, actually running well ahead of the pre-COVID trend.

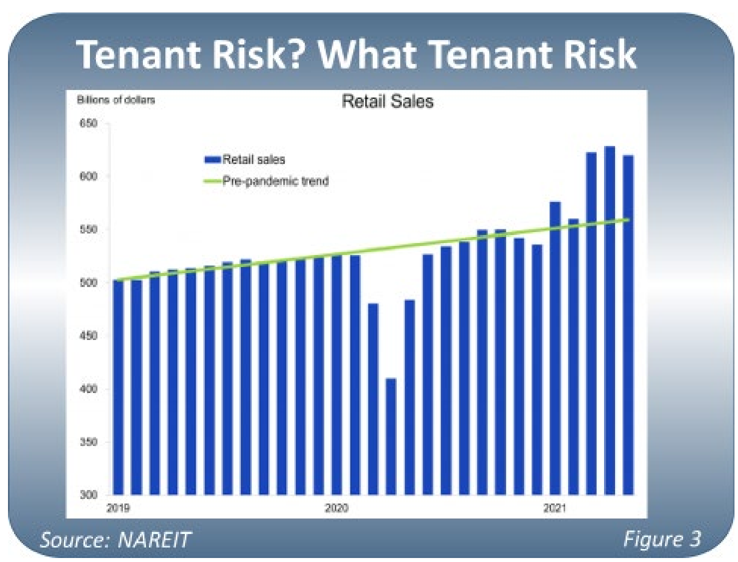



Figure 3

For all the fear that "retail is dead," it appears to be alive and kicking.

We already own a handful of REITs in **Healthcare Trust of American (NYSE: HTA)**, **Physicians Realty Trust (NYSE: DOC)** and **Starwood Property Trust (NYSE: STWD)**, and Starwood in particular has been a strong performer for us.

But today, I want to go a little more general. I want broad exposure to the entire sector, and I want it at a discount.

That's exactly what we're getting in the **Nuveen Real Estate Income Fund (NYSE: JRS).**

JRS is a closed-end fund that invests in the common and preferred stock of real estate companies. As of the most recently published portfolio data, 70% of the fund is invested in common stocks with the remaining 30% invested in preferreds.

The shares have been trending sharply higher for the past year, but I see them going a lot higher from here. And here's why…

## Buying on the Cheap

Closed-end funds are very different than traditional mutual funds.

In a traditional mutual fund you (or your broker) send cash to the fund. The manager then takes your cash and uses it to buy more stocks, bonds or other securities. When you want your money back, the manager sells off a small portion and sends you the cash.

But in a closed-end fund, the number of shares is generally fixed. When you want to buy shares, you simply buy them on the New York Stock Exchange the same way you'd buy a stock.

### Nuveen Real Estate Income Fund (NYSE: JRS)


Source: BigCharts | Figure 4

### JRS Discount to NAV


Source: CEFConnect | Figure 5

### JRS Top Holdings

| | | |
|---|---|---|
| Prologis Inc | $30.57M | 6.73% |
| Equinix Inc | $21.77M | 4.79% |
| American Homes 4 Rent Class A | $18.88M | 4.16% |
| Public Storage | $17.13M | 3.77% |
| Equity Residential | $16.07M | 3.54% |
| Highwoods Properties, Inc. 8.63% | $15.89M | 3.50% |
| AvalonBay Communities Inc | $15.77M | 3.47% |
| Alexandria Real Estate Equities Inc | $14.65M | 3.22% |
| Healthpeak Properties Inc | $12.72M | 2.80% |
| Boston Properties Inc | $12.60M | 2.77% |

Source: CEFConnect | Figure 5

This means that the price of the fund can be wildly different than the value of the stocks it owns.

If you've read prior issues of the *Sizemore Income Letter,* you know these are exactly the kinds of opportunities I look for. I love buying those proverbial 90-cent dollars.

Well, JRS isn't quite a 90-cent dollar, but it's close. The fund trades at an 8% discount to net asset value, making it a 92-cent dollar. Close enough!

Like most closed-end funds, JRS goes through cycles where it is alternatively overpriced or underpriced. As recently as 2017, the fund traded at a premium to net asset value, meaning investors were actually paying about $1.01 for a dollar's worth of assets, and often the discount is only a few percent. So, while an 8% discount is by no means the cheapest we've ever seen in this fund, I consider that a deep enough discount to get my attention.

## Not All Real Estate Is Created Equal

Will Rogers might have been right about land. There's not making any more of it… at least not until Elon Musk is successful in colonizing Mars. And let's get serious, that might be a while.

But while land might be in short supply, I really can't say the same for certain types of buildings. Lower-tier malls have been suffering for decades. That's not something I'd really want to own as a long-term investment.

And lower-tier office buildings? We may see a glut in those for decades. The pandemic may essentially be over here, and Americans are returning to their offices. The great work-from-home experiment has largely run its course. But at the margin, companies are scaling back. Not all employees will be returning to the office. Some will continue working from home, and others might try a hybrid approach where they're in the office only a few days per week.

This means a lot of marginal office space simply won't get used… and that's not anything I want to own.

Well, JRS' management team appears to feel the same way. You won't find a lot of cruddy retail or office properties in the portfolio. The top two stocks in the portfolio are logistical REIT **Prologis Inc (NYSE: PLD)** and datacenter REIT **Equinix Inc (Nasdaq: EQIX)**. Between the two, they make up more than 11% of the portfolio.

These two REITs are not just "Amazon proof" in that they can survive the continued onslaught against traditional retail from online giants like Amazon. They actually *benefit* from it, Amazon is a major tenant of Prologis, and the REIT provides warehousing and logistical support for the company. And Equinix's datacenters house Amazon servers.

Logistics and datacenters may be the two biggest trends in real estate right now, but they're not the only pockets of the market where JRS has exposure. The fund also has exposure to the post-COVID housing boom via **American Homes 4 Rent (NYSE: AMH)** and additionally has large positions in storage units and apartments.

So, suffice it to say, JRS isn't going dumpster diving in cheap but low-quality issuers. They're buying solid operators in growing industries. They're buying the good stuff.

## Let's Talk Dividends

First and foremost, this is an income letter, so let's talk dividends. At current prices, JRS yields about 7.1%. That's be no means the highest-yielding position in our portfolio, but it's still extremely competitive.

Furthermore, we don't need to worry about inflation eroding the value of the dividend. As a general rule, REITs have inflation provisions in their rental agreements. As prices rise, so do the rents that REITs collect.

And finally, there is one last aspect I'd like to mention. I said earlier that "everything" seemed expensive right now. Well, I'm comfortable continuing to have exposure in this environment because I believe we still have at least a few more months before the bull runs out of steam.

But all the same, I'm not wildly happy about throwing new money into this market given where pricing is.

This is where closed-end funds are nice. Because the pool of capital is fixed, the managers aren't forced to buy already-expensive issues whenever new money comes into the fund. And importantly, they also can't be forced to liquidate due to redemptions when things get dicey. Investors wanting out simply sell the shares and move on.

I like this because it gives the fund managers the flexibility to buy smaller or less liquid issues without having to worry about having to sell due to redemptions. I consider that a really underrated benefit of holding closed-end funds over traditional mutual funds and ETFs.

Let's get to it. In JRS, we have an inflation-proof, high-income fund with access to some of the biggest long-term trends in real estate. We can't know with certainty how things are going to unfold as the Fed reaches the end of this policy regime. But this is something we want to own no matter what happens next. And, as always, if the market has other ideas, we'll protect ourselves with a stop loss.

In a closed-end fund, returns come from three sources. There is the income from the dividend, of course. And there is

So, with no further ado…

**Action to take: Buy shares of the Nuveen Real Estate Income Fund (NYSE: JRS) at market. Set an initial stop loss at $8.68 based on closing prices.**

Note that JRS is IRA friendly. You can hold the shares in your IRA without having to worry about any UBTI issues.

## Portfolio Update

The volatility this month took a bite out of some of our commodity plays. We're down about 8% in **BHP Group (NYSE: BHP)** and a little over 4% in **Newmont Corp (NYSE: NEM)**.

But the news here isn't all bad. In fact, we're doing quite well overall. We're still up over 35% in **Vale (NYSE: VALE)** in about four months, and we're off to a nice start in the **ClearBridge Energy Midstream Opportunity Fund (NYSE: EMO)**, up about 4%.

Overall, our strategy of seeking out high yields in the commodities and basic industries sectors is working.

The Fed has been insistent that inflation will be "transient," or temporary. This is just a function of the economy being turned upside down by the pandemic and the reopening and prices will stabilize soon enough. And already, we're seeing some of this. As an example, consider lumber prices. After spiking and going parabolic, rising over 500% at one point, lumber prices are now in retreat again.

But what about labor? Employers all across the country are complaining of labor shortages, and there is on surefire way to fix that: raise wages. If you raise wages high enough, high school kids will drop their iPhones and start filling in job applications. Stay-at-home spouses might decide to reenter the workforce. And the proverbial couch potato might be persuaded to actually leave the house.

But that kind of wage inflation will also crimp corporate profits and likely lead to further increases in consumer prices. So, until something changes the path we're on, inflation would seem to be the status quo.

The change will eventually come. Either inflation will become intolerable enough to make the Fed jack up rates, or the entire dog and pony show will come undone by a bear market. Something will happen. And it may happen sooner rather than later.

But until it does, we're going to keep looking for opportunities while protecting ourselves with stop losses.

That's going to wrap it up for now. We'll pick this up next month.

Until then, keep cashing those dividend checks!

P.S.: Apart from writing this newsletter, I run a full-service wealth management firm along with my colleagues. At **Sizemore Capital Management**, we build income portfolios like those I write about in the *Sizemore Income Letter*.

But we also do a lot more than that. We manage a suite of low-volatility strategies offering low correlation to the S&P 500. If you think your portfolio is a little too exposed to the stock market right now, let's talk. I may have some alternatives that can offer competitive returns without the heartburn.

If you'd like for me to take a look at your portfolio and offer some recommendations, contact me at info@sizemorecapital.com.

## The Sizemore Income Letter Portfolio

| Stock | Ticker | Entry Date | Buy Price | Recent Price | Stop Loss | Yield | Cumulative Dividends | Total Return | IRA Friendly? | Action |
|---|---|---|---|---|---|---|---|---|---|---|
| Nuveen Real Estate Income | JRS | 6/25/2021 | $10.77 | $ 10.77 | $ 8.68 | 7.06% | $ - | 0.00% | Yes | Buy |
| ClearBridge Energy Midstream Opportunity | EMO | 5/26/2021 | $21.94 | $ 23.18 | $17.30 | 6.86% | $ - | 5.65% | Yes | Buy |
| First Trust Dynamic Europe Equity Income | FDEU | 5/26/2021 | $13.68 | $ 13.55 | $11.76 | 5.26% | $ - | -0.95% | Yes | Buy |
| Newmont Corporation | NEM | 4/27/2021 | $65.72 | $ 62.66 | $55.43 | 2.97% | $ - | -4.66% | Yes | Buy |
| BHP Group | BHP | 2/25/2021 | $78.04 | $ 71.62 | $61.50 | 4.27% | $ - | -8.23% | Yes | Buy |
| Vale SA | VALE | 2/25/2021 | $17.40 | $ 22.80 | $15.13 | 5.75% | $ 0.77 | 35.44% | Yes | Buy |
| Magellan Midstream Partners | MMP | 1/29/2021 | $44.41 | $ 50.19 | $41.78 | 8.27% | $ 1.03 | 15.33% | No | Buy |
| WisdomTree Emerging Markets High Dividend Fund | DEM | 12/31/2020 | $41.22 | $ 46.40 | $40.42 | 4.13% | $ 0.18 | 12.99% | Yes | Buy |
| Healthcare Trust of America | HTA | 11/20/2020 | $26.80 | $ 27.83 | $23.45 | 4.61% | $ 0.32 | 5.04% | Yes | Buy |
| Physicians Realty Trust | DOC | 11/20/2020 | $17.80 | $ 18.98 | $15.19 | 5.00% | $ 0.23 | 7.92% | Yes | Buy |
| AllianceBernstein Holding, LP | AB | 11/6/2020 | $30.85 | $ 45.14 | $33.04 | 6.95% | $ 0.97 | 49.47% | No | Hold |
| Main Street Capital | MAIN | 9/25/2020 | $29.74 | $ 42.03 | $32.96 | 5.96% | $ 0.82 | 44.08% | Yes | Buy |
| Iron Mountain | IRM | 8/25/2020 | $30.22 | $ 43.50 | $35.52 | 5.66% | $ 1.24 | 48.04% | Yes | Hold |
| Starwood Property Trust | STWD | 8/25/2020 | $15.70 | $ 26.22 | $18.15 | 7.66% | $ 0.96 | 73.12% | Yes | Buy |
| Dow Inc. | DOW | 6/24/2020 | $38.45 | $ 63.15 | $47.25 | 4.07% | $ 0.70 | 66.06% | Yes | Buy |
| Tortoise Essential Assets Income Term Fund | TEAF | 6/24/2020 | $10.73 | $ 15.06 | $11.94 | 6.18% | $ 0.60 | 45.95% | Yes | Buy |
| LyondellBasell Industries | LYB | 5/22/2020 | $60.39 | $ 103.34 | $79.23 | 3.76% | $ 1.05 | 72.86% | Yes | Buy |
| Invesco Adv. Municipal Income Trust II | VKI | 4/23/2020 | $10.12 | $ 12.15 | $11.32 | 4.78% | $ 0.51 | 25.05% | No | Hold |
| Ares Capital Corporation | ARCC | 4/23/2020 | $11.35 | $ 19.29 | $15.92 | 8.27% | $ 1.20 | 80.53% | Yes | Buy |