The Sizemore Income Letter

August 2021

Making Money in Mortgages

By Charles Lewis Sizemore, CFA

I'll be adding a fat 8.7% yielder this month. I'm getting that out now, up front, so that you're sure to read until the end!

But before I get to that, I want to quickly revisit one of my themes of the past year.

You've probably noticed I've been big on commodity stocks in 2021.

Well, I still am. And for the most part, it's been a good trade for us. We're modestly down in a handful of commodity stocks, but we knew there would be a little volatility going into these. It's the nature of the beast.

When these stocks take a major leg up, they can really move. And we're getting paid handsomely to wait for that move.

In a market that's still largely dominated by tech names, it can be a little lonely fishing in the high-yield commodity-stock pond.

So, I was happy to see *Barron's* writer Andrew Barry making many of the points I've been making in his column this past week:

> *Commodity producers look appealing after a pullback from May highs. While prices for industrial metals like copper and iron ore have been weaker, Chris LaFemina, a mining analyst at Jefferies, is upbeat on the sector. "The soft patch will end," he says. "There won't be a massive acceleration in demand, but things will start to pick up, and there are supply constraints in commodities like copper that will result in demand growing faster than supply."*
>
> *Among diversified miners, BHP (ticker: BHP), at $66, is down 20% from its peak; Rio Tinto (RIO) is off 19%, to $75; Anglo American (NGLOY) is off 13%, to $21; and Freeport-McMoRan (FCX), a global copper producer, is down 21% from its peak to $36.*

We are, of course, long BHP, as well as Vale SA (NYSE: VALE) and Newmont Corp (NYSE: NEM).

I like the sober analysis here. While I do expect demand to pick up substantially due to increased infrastructure spending here and abroad, it's not necessary for our bullish thesis. Supply is still constrained, so we don't need a major surge in demand to push prices higher. It would help turn a good investment into a *great* one, of course. But it's something I'd view as a bonus.

We're still a little closer to our stops than I'd like to see, and it's entirely possible we get knocked out by any new selling. But for now, we'll plan on staying the course.

Now, on to that fat 8.7% yielder…

A Blue Chip Mortgage REIT on Sale

This month, I'm going to recommend you pick up some shares of blue-chip mortgage REIT **AGNC Investment Corp (NYSE: AGNC).**

First a little background is in order.

I've recommended plenty of equity REITs in these pages, and you likely have a good understanding of the asset class. REITs are a special class of corporation that avoid corporate taxation so long as they pay out at least 90% of their income in the form of dividends.

Needless to say, avoiding corporate income taxes frees up a lot of cash. This goes a long way to explaining why REITs are such dividend workhorses. Every dollar not paid to the IRS is another dollar available to be paid to shareholders like you and me.

Mortgage REITs are a slightly different animal. They get the same tax benefits, but rather than own physical property, such as office towers or apartments, they own mortgage assets, often Fannie Mae and Freddie Mac bonds, and they juice them with a little leverage to get higher yields.

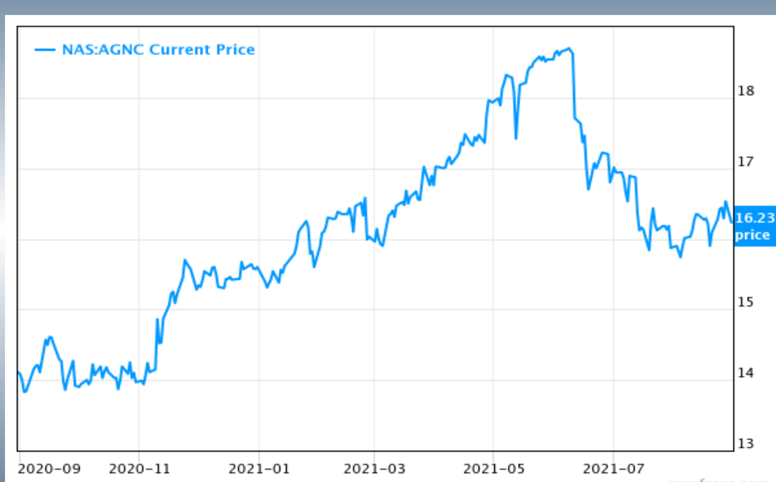
This isn't our first rodeo in mortgage REITs. We've owned shares of **Starwood Property Trust (NYSE: STWD)** for a little over a year, and we've done well. Including dividends, we're up over 76%.

Not bad!

I can't promise we'll make 76% in every mortgage REIT. But I do expect us to do well in AGNC.

The shares were up about 20% from the start of the year through early June before giving up most of those gains. Prices tumbled for most of June and July on the news of a possible secondary offering.

AGNC Investment Corp (NYSE: AGNC)



Source: GuruFocus *Figure 1*

That's ok. This reset in the stock price has given us an excellent entry point. At these levels, the shares are priced to deliver respectable capital gains on top of the nearly 9% in dividends.

Formerly a Minefield, Now a Safe Haven

Mortgage REITs, or mREITs, have been relatively stable for the past several months. In fact, you could go so far as to call them boring. But it's not always like that.

Let's go back in time to dark early days of the pandemic last year. It got *ugly.*

With the economy shut down, many tenants either wouldn't or couldn't pay their rent. Panicked investors sold first and asked questions later, dumping their mortgage bonds into an illiquid market.

That was a major problem for the most leveraged mREITs holding any assets *not* backstopped by Fannie Mae or Freddie Mac. The value of their portfolios dropped relative to their margin loans, which resulted in nasty margin calls. Many of those mortgage REITs took severe and permanent losses.

AGNC Trading Below Scrap Value

Source: GuruFocus *Figure 2*

If you got sucked into that mess… well, I'm sorry to hear that. I took some losses myself, and it horrid to live through.

Well, here's the good news. Any mortgage REIT trading today is a survivor. They lived through the apocalypse and came out on the other side.

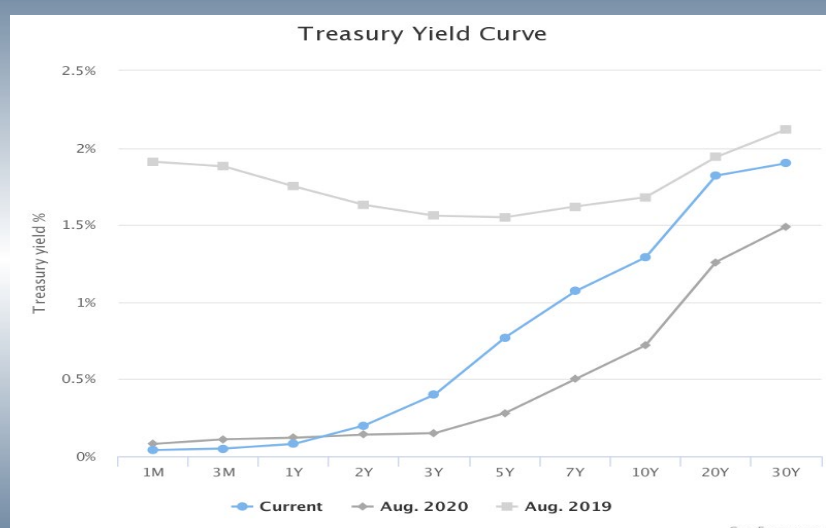
Whatever the future might hold, it's not likely to be as traumatic as a once-in-a-century pandemic. And AGNC in particular is a solid, no-drama income option.

Take a minute and say "AGNC" out loud. It sounds like "agency," doesn't it?

That's no coincidence. AGNC Investment specializes in agency mortgage-backed securities (i.e. those backed by the government-sponsored entities Fannie Mae and Freddie Mac), making it one of the safest plays in this space.

For most of AGNC's history, the stock has traded at a premium to book value. This makes sense. AGNC can borrow

Yield Curve

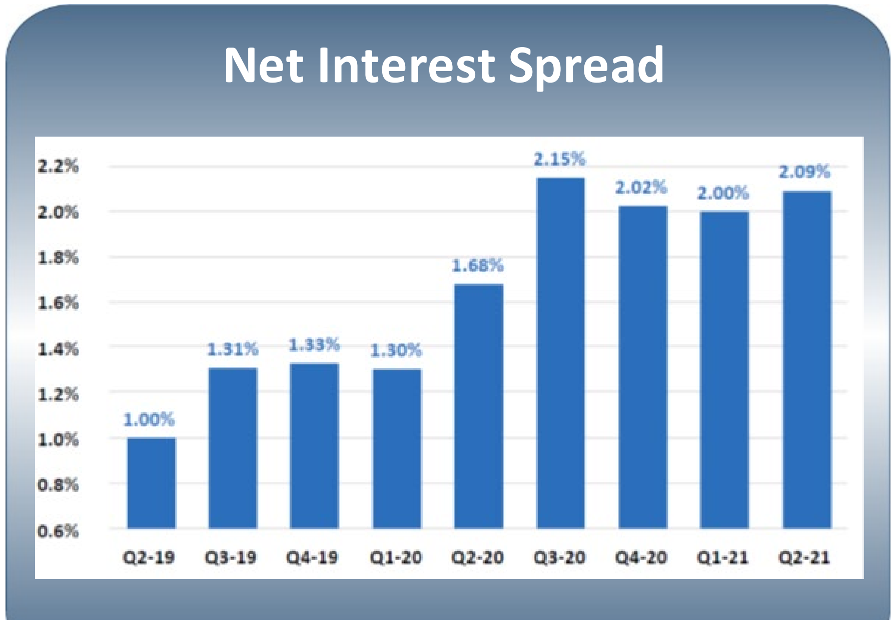


Source: GuruFocus *Figure 3*

cheaply to juice its returns, and we as investors pay a premium to have access to that cheap leverage.

But during the pits of the pandemic, AGNC dipped *deep* into discount territory. That discount has narrowed over the past year, but shares remain about 7% below book value.

In other words, you could hypothetically buy up the entire company, sell off its mortgage assets and pay off its debts, and walk away with a risk-free 7% profit.



Source: Company Filings

Figure 4

A License to Mint Money

Mortgage REITs aren't necessarily something you'd want to buy and hold forever. There are good times to own them… and bad times to own them.

And as it would turn out, this is a *great* time to own them.

Remember that mortgage REITs juice their returns by borrowing cheaply at short-term rates and then using the proceeds to buy higher-yielding longer-term assets.

Well, check out Figure 3 on the previous page and compare today's yield curve (blue line) to the yield curve from 2019 (light grey line).

2019 was a nightmare market for mortgage REITs. There was virtually no difference between short-term and long-term rates. And not surprisingly, profitability suffered.

But today's yield curve looks fantastic. Short-term rates are anchored at zero, even while long-term rates are back to near 2019 levels.

AGNC's net interest spread (Figure 4), or the difference between the rate at which it borrows and the rate and which it invests, is now more than double its levels of two years ago.

It's odd to see AGNC trading at a large discount to net asset value at a time when its net interest spread is this wide. And frankly, I don't believe that it will be at a discount for much longer. Until something fundamentally changes, and the Fed finally decides to hike short-term rates, AGNC will remain in its ideal sweet spot.

So, with no further ado…

Action to take: Buy shares of AGNC Investment Corp (NYSE: AGNC) at market. Set an initial stop loss at $13.52 based on closing prices.

If AGNC were to return its "normal" state of trading at about 1.1 times book value, we could see capital gains of close to 20% in a hurry. Adding in another 8.7%

in dividends, and we have a respectable return.

Mortgage REITs aren't without their risks. Management does the best they can to hedge the portfolio against sudden changes in interest rates, but there's always that potential for an unexpected curve ball they didn't plan for. And that's just fine. It's why we protect ourselves with stop losses. If the Fed does something out of the ordinary that sends the credit markets into a spiral, we won't be around to deal with the aftermath. We'll honor our stops and move on.

Update on the Forever Portfolio

I expected solid returns when I created the Forever Portfolio back in March of last year. My goal, in the middle of the pandemic, was to create a bullet-proof portfolio that could survive any conceivable threat… even COVID.

So far, so good. Four out of the original 10 recommendations are now up over 100%, and senior living REIT Ventas (NYSE: VTR) is now up nearly 200%.

I don't expect returns like that every year, of course. Those kinds of returns were only made possible by the depressed pricing we had last March.

But I do consider every stock on this list worth owning at current prices, and that includes even **AT&T (NYSE: T)**. I may never fully regain my faith in management after they bungled the Time Warner acquisition and then divestment. That was a royal screw-up. But the company will be much more conservatively financed once the dust settles, and it's hard to find a better yield among lower-risk blue chips these days.

I have no specific action to take today in the Forever Portfolio. But if you have conservative money looking for a home, I consider this a great destination for it.

Portfolio Review

Now, let's take a peek at the core portfolio.

Other than AGNC, I'm probably most excited about the prospects for the **Nuveen Real Estate Income (NYSE: JRS**). REITs have been doing particularly well of late, and we're up a

Stock	Ticker	Entry Date	Buy Price	Recent Price	Stop Loss	Yield	Cumulative Dividends	Total Return	IRA Friendly?
Philip Morris Internat	PM	3/30/2021	$ 89.35	$ 103.07	None	4.90%	$ 1.20	16.70%	Yes
Altria Group	MO	3/19/2020	$ 37.10	$ 49.70	None	7.27%	$ 5.12	47.76%	Yes
Realty Income	O	3/19/2020	$ 48.08	$ 72.06	None	4.03%	$ 3.75	57.67%	Yes
AT&T	T	3/19/2020	$ 31.15	$ 27.23	None	6.91%	$ 3.64	-0.90%	Yes
Enterprise Products Partners	EPD	3/19/2020	$ 14.52	$ 22.26	None	7.62%	$ 2.24	68.70%	No
Kinder Morgan	KMI	3/19/2020	$ 11.20	$ 16.34	None	6.29%	$ 1.32	57.70%	Yes
Ventas	VTR	3/19/2020	$ 19.98	$ 55.43	None	3.00%	$ 3.04	192.66%	Yes
Public Storage	PSA	3/19/2020	$ 187.60	$ 320.55	None	2.59%	$ 10.00	76.20%	Yes
International Paper	IP	3/19/2020	$ 30.13	$ 59.37	None	3.51%	$ 2.57	105.56%	Yes
STAG Industrial	STAG	3/19/2020	$ 21.71	$ 42.57	None	3.62%	$ 1.93	104.96%	Yes
Retail Opportunity Investments	ROIC	3/19/2020	$ 7.25	$ 18.03	None	2.62%	$ 0.42	154.48%	Yes
Average						**4.76%**		**80.13%**	

little over 5% in the position in two months.

I expect a lot more where that came from.

To start, JRS's net asset value has risen at a faster clip than its share price, meaning that its discount to NAV has actually widened over the past two months. The shares now trade at just 92% of book value.

There's no magic rule that says a closed-end fund has to trade at or near book value, but it's worth noting that at various points in its history, JRS actually traded at a large premium. For much of the 2009 – 2013 period, the shares flirted with a 10% premium to NAV.

We'll see. But while we wait, we're enjoying a nice 6.7% dividend while the shares trend higher.

Action to take: If you don't already own shares, consider adding the Nuveen Real Estate Income (NYSE: JRS) today.

I mentioned Starwood Property Trust earlier, and it remains a buy. It's one of our best-performing positions with total returns of over 76%.

Apart from Starwood, our best performing positions remain **Dow Inc (NYSE: DOW), LyondellBasell Industries (NYSE: LYB)** and **Ares Capital Corporation (NYSE: ARCC)**, up 74%, 78% and 94%, respectively.

We were able to snag those returns because we bought the stocks at insanely cheap prices, during the pandemic, when all investors wanted to touch was tech.

But here's the thing… all three are still quite cheap. Dow trades for just 11 times next year's expected earnings, and Lyondell just 7. I would be thrilled to buy these today, at current prices.

So…

Action to take: If you don't already own shares, consider buying shares of Dow Inc (NYSE: DOW) and LyondellBasell Industries (NYSE: LYB) today.

Ares Capital isn't quite the steal DOW or LYB are, but it's still a buy. The shares trade at 1.1 times book value, which is a very modest premium for this company. This isn't a "back up the truck" moment, but the shares still look great at these prices.

Action to take: If you don't already own shares, consider buying shares of Ares Capital Corporation (NYSE: ARCC) today.

I mentioned commodity stocks at the beginning of this issue, and I'd reiterate that that I'm still wildly bullish on our industrial commodity plays. If you don't already own Vale and BHP, I consider both to be very attractive here as destinations for new money.

I'm slightly less enthusiastic about Newmont Corp given how close it is to its stop. I'm not "officially" moving it to a hold just yet, but I'd say that with limited funds at your disposal, I'd make sure to invest in Vale and BHP first.

Action to take: If you don't already own them, take advantage of the recent weakness to add shares of Vale SA (NYSE: VALE) and BHP Group (NYSE: BHP).

I moved document and data storage REIT **Iron Mountain (NYSE: IRM)** to a hold several weeks ago, and I'd like to revisit our strategy again today. Iron Mountain has been a really solid performer for us, and we're up a good 62% including dividends. I see no reason to dump a stock that continues to rise.

But all the same, I can't say I consider the stock attractive at today's prices. If I didn't already own it, I wouldn't be buying it here.

Be on the lookout. If we get any weakness in the stock in the coming weeks, that may be our cue to take our profits and move on.

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

Until then, stay safe out there, and 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
AGNC Investment Corp.	AGNC	8/30/3031	$16.23	$ 16.23	$ 13.52	8.71%	$ -	0.00%	Yes	Buy
Morgan Stanley Emerging Markets Domestic Debt	EDD	7/30/2021	$6.15	$ 6.16	$ 5.50	6.60%	$ -	0.16%	Yes	Buy
Nuveen Real Estate Income	JRS	6/25/2021	$10.77	$ 11.36	$ 9.27	6.68%	$ -	5.48%	Yes	Buy
ClearBridge Energy Midstream Opportunity	EMO	5/26/2021	$21.94	$ 20.98	$ 17.30	7.10%	$ 0.38	-2.64%	Yes	Buy
First Trust Dynamic Europe Equity Income	FDEU	5/26/2021	$13.68	$ 13.60	$ 11.76	5.29%	$ 0.18	0.73%	Yes	Buy
Newmont Corporation	NEM	4/27/2021	$65.72	$ 57.52	$ 55.43	3.74%	$ 0.55	-11.64%	Yes	Buy
BHP Group	BHP	2/25/2021	$78.04	$ 67.67	$ 61.57	4.01%	$ -	-13.29%	Yes	Buy
Vale SA	VALE	2/25/2021	$17.40	$ 19.32	$ 15.28	4.14%	$ 0.77	15.41%	Yes	Buy
Magellan Midstream Partners	MMP	1/29/2021	$44.41	$ 49.26	$ 41.78	8.65%	$ 2.06	15.55%	No	Buy
WisdomTree Emerging Markets High Dividend Fund	DEM	12/31/2020	$41.22	$ 45.14	$ 40.42	4.48%	$ 0.82	11.49%	Yes	Buy
Healthcare Trust of America	HTA	11/20/2020	$26.80	$ 30.23	$ 23.45	4.61%	$ 0.96	16.38%	Yes	Buy
Physicians Realty Trust	DOC	11/20/2020	$17.80	$ 18.44	$ 15.30	4.49%	$ 0.69	7.47%	Yes	Buy
AllianceBernstein Holdings, LP	AB	11/6/2020	$30.85	$ 52.19	$ 36.20	6.77%	$ 1.78	74.94%	No	Hold
Main Street Capital	MAIN	9/25/2020	$29.74	$ 41.70	$ 32.96	5.93%	$ 1.85	46.42%	Yes	Buy
Iron Mountain	IRM	8/25/2020	$30.22	$ 46.69	$ 35.76	5.30%	$ 2.48	62.69%	Yes	Hold
Starwood Property Trust	STWD	8/25/2020	$15.70	$ 25.72	$ 18.15	7.38%	$ 1.92	76.05%	Yes	Buy
Dow Inc.	DOW	6/24/2020	$38.45	$ 63.98	$ 47.25	4.53%	$ 2.80	73.68%	Yes	Buy
Ecofin Sustainable and Social Impact Term Fund	TEAF	6/24/2020	$10.73	$ 14.65	$ 12.19	6.14%	$ 0.98	45.62%	Yes	Buy
LyondellBasell Industries	LYB	5/22/2020	$60.39	$ 101.94	$ 79.23	4.27%	$ 5.33	77.63%	Yes	Buy
Invesco Adv. Municipal Income Trust II	VKI	4/23/2020	$10.12	$ 12.75	$ 11.46	4.70%	$ 0.75	33.40%	No	Hold
Ares Capital Corporation	ARCC	4/23/2020	$11.35	$ 19.97	$ 16.45	8.20%	$ 2.00	93.57%	Yes	Buy