The Sizemore Income Letter

January 2022

Volatility is Back

By Charles Lewis Sizemore, CFA

Well, *that* wasn't fun.

Volatility came back with a vengeance in January. Between the prospect of war with Russia, continued inflation woes and the market finally deciding to take Fed Chairman Jerome Powell seriously when he says he's hiking rates… it was enough to send the market into a tailspin. The Nasdaq dipped into correction territory and is down 14 percent as I write this. And at its intraday lows, it came close to hitting 20%. The damage in the S&P 500 is less severe, but the index is still down about 10%.

Looking at individual stocks, it gets worse. Tesla was down about 30% from its recent highs. Amazon.com was down about 20%. Netflix is down an astounding 40%.

And remember, the market was hitting all-time highs in the early days of January!

Meme stocks are getting killed. Bitcoin is getting killed. I haven't checked prices lately, but I'm going to go out on a limb and say that the prices of non-fungible tokens have likely taken a beating too.

You can see the evidence in the CBOE Volatility Index, better known as the VIX. The financial press likes to call this the "fear index." And yes, a look at it today will tell you that investors are scared.

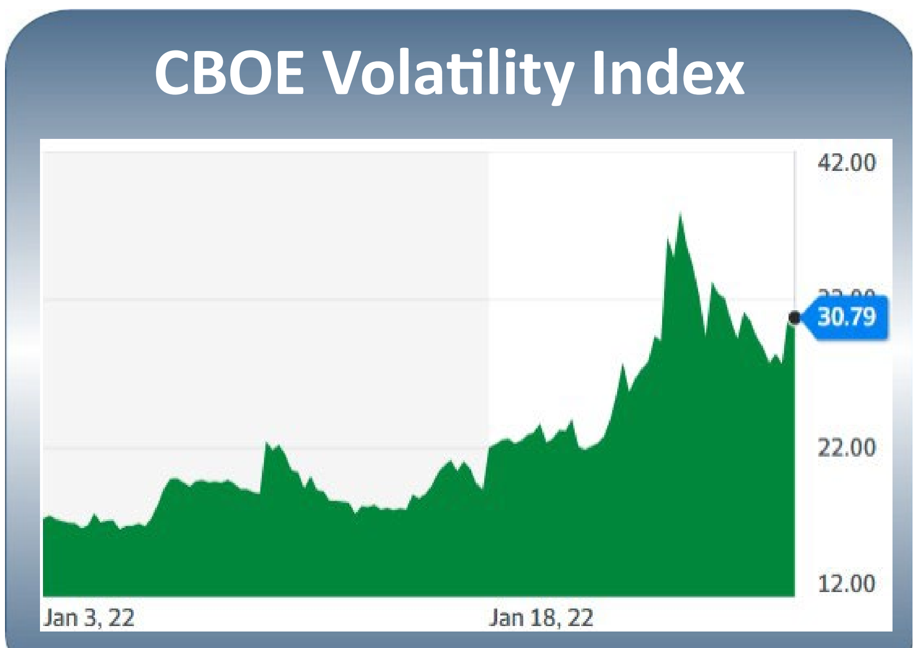

Figure 1

So, what now? Is it over? Or is there more pain to come?

You remember what I said last month. *"It's difficult to make predictions, especially about the future."*

I said in the December monthly issue that it was likely we'd have a correction in 2022. But I'll admit, I really didn't expect it to hit just days after I published the issue.

I'll repeat what I said last month:

I expect a deep correction in 2022 and possibly a bear market.

Stock prices stopped making sense a long time ago. The Shiller P/E is closing in on the all-time highs hit during the 1990s dot-com mania, and the price/sales ratio (Figure 3) is more than 50% higher than its 1990s highs. We're in uncharted territory here.

But I'll also repeat what I wrote immediately after that:

Let me be clear that I'm <u>not</u> selling all of my stocks and digging a bunker in Idaho to hide in.

I am, however, recommending you keep your position sizes a little smaller than usual and keep your stops a little tighter. And I recommend that you dedicate a little more of your portfolio than usual to shorter term strategies that aren't tied directly to the market. It only makes sense.

Bearish sentiment got really extreme really fast. So I wouldn't be surprised to see a relief rally here. A lot of the weaker hands have already thrown in the towel.

But this doesn't escape the bigger issues. Stocks are still expensive, and the Fed is still draining liquidity out of the market. This doesn't mean stocks *have* to fall. Stocks price movements defy logic all the time

But it does mean that stocks face headwinds. *Serious* headwinds.

So, let's keep our gameplan in place.

2022 Correction Plan

- Keep a little more cash on hand.
- Keep your position sizes a little smaller than usual.
- Keep a good percentage of your portfolio in non-market alternatives.
- To the extent you buy and hold stocks, focus on quality dividend payers.
- Be willing to make short-term trades, and be sure you have an exit plan.

Figure 2

My best guess – and let me reiterate that it is a *guess* – is that we get some sort of relief rally followed by more downside.

The severity of that downside will likely depend on two factors:

1. How fast will the Fed tighten?
2. Do earnings decelerate?

I'm more worried about the second point than the first. Even under the most aggressive scenarios, it's hard to see the Fed going full throttle and jacking rates the sky overnight.

But earnings are another story. They've been massively inflated by the distortions of the pandemic. The reality is that few Americans lost their jobs in the pandemic, but most of us got free money in the form of stimulus payments. Those got spent. And now they're done.

Furthermore, how many Peloton machines do you really need? The excess spending in 2020 and 2021 pulled forward spending that would have normally happened in 2022 or later.

Even in tech, we had expenses pulled forward. Who's going to *start* a Zoom or DocuSign subscription now? I use those services daily, but I already have a subscription and I certainly won't be getting a new one. And I don't know anyone who is.

At any rate, we won't know for sure that the correction is finished until the new bull market is already well underway, whether that day is tomorrow or two years from now. Until then, we just need to be careful and follow our gameplan.

Finding Gems

This doesn't mean we have to sit on our hands. I have a recommendation this month that pays a nice 9.2% divided and trades for about 88 cents on the dollar.

Let me introduce you to the **Vertical Capital Income Fund (NYSE: VCIF)**.

You're familiar with mortgage REITs. We recently had **AGNC Investment Corp (NYSE: AGNC)** in the portfolio, though we were unfortunately stopped out earlier this month.

Mortgage REITs buy large portfolios of mortgages and mortgage-backed securities, lever them up, and then turn them into high-yield income machines.

Well, VCIF isn't a mortgage REIT. It's a closed-end fund, but it essentially functions like a mortgage REIT. VCIF invests in a portfolio of US mortgages, but it has a special niche. Rather than buy the same Fannie Mae and Freddie Mac securities that AGNC and other mortgage REITs tend to buy, VCIF focuses on loans that for a variety of reasons aren't eligible to be held by Fannie or Freddie. This could be due to the mortgage previously being delinquent, the borrower changing

Vertical Capital Income Fund

Figure 3

VCIF Portfolio Breakdown

Number of Whole Loans	735
Total Unpaid Balance (UPB)	$118,816,295
Average UPB per Loan	$161,655
Total Collateral (Real Estate) Value	$172,853,980
Average Collateral (Real Estate) Value per Loan	$235,175
Weighted Avg. Loan to Value (LTV)	68.74%
Weighted Avg. Acquisition Discount (as % of UPB)	12.75%
Weighted Avg. Interest Rate	6.09%
% of Performing Loans*	89.70%
Weighted Average FICO	664

**<60 Days past due*

Figure 4

VCIF Portfolio by State

Top Geographic Exposure by State

As % of UPB

Florida	18.38%
California	15.10%
Texas	12.40%
New York	7.56%
Pennsylvania	5.38%
Georgia	5.37%
Tennessee	3.56%
Maryland	3.28%
New Jersey	2.58%
Washington	2.26%

Figure 5

employment during the underwriting process of any of a million other things.

Because these loans are effectively "orphans" that the bigger funds can't buy, VCIF can pick them up at a good price. VCIF's current portfolio was purchased at a 12.75% discount to the balance of the loans.

Anyone with a memory of the 2008 meltdown knows that mortgage lending can be wildly risky. Well, VCIF avoids the potential pitfalls by maintaining a conservative book. 90% of the loans are "performing" (i.e. not at some stage of workout) and the portfolio has a weighted average loan to value of over 68%.

If you're unfamiliar with industryspeak, that means they lend out 68 cents for every dollar worth of appraised house. That gives the company a lot of "wiggle room" in the event they need to foreclose on a home and sell it.

VCIF also avoids larger home and jumbo mortgages. Its average loan size is just $161,655 and the average value of the collateral (the house) is just $235,175. These are homes that could easily be unloaded on a private equity investor if push came to shove.

And, critically importantly, the company only buys first-lien mortgages. In the even that things got nasty, VCIF owns the collateral with no competing claims and can do whatever they need to do.

The portfolio is also well diversified by state. Florida, California and Texas make up the largest proportions of the portfolio, at 18.38%, 15.10% and 12.40%, respectively.

I mentioned that VCIF was "like a mortgage REIT." But there is one critical difference. Mortgage REITs are generally very highly leveraged. They have sophisticated traders that manage the risk of that leverage, but at the end of the day, you have to trust them not to screw it up.

VCIF Cumulative Dividends

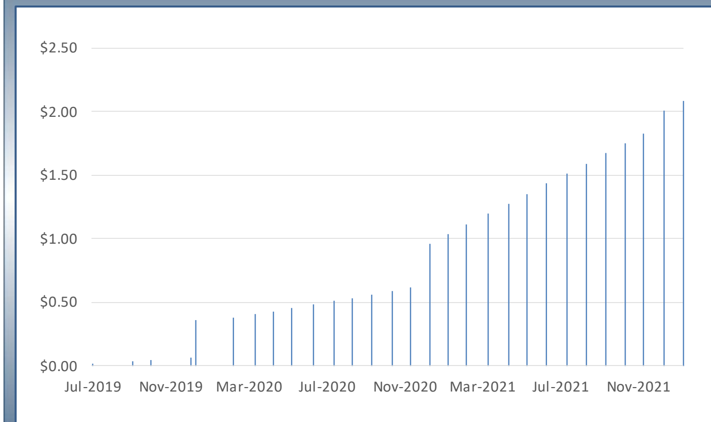

Figure 6

VCIF Discount to NAV

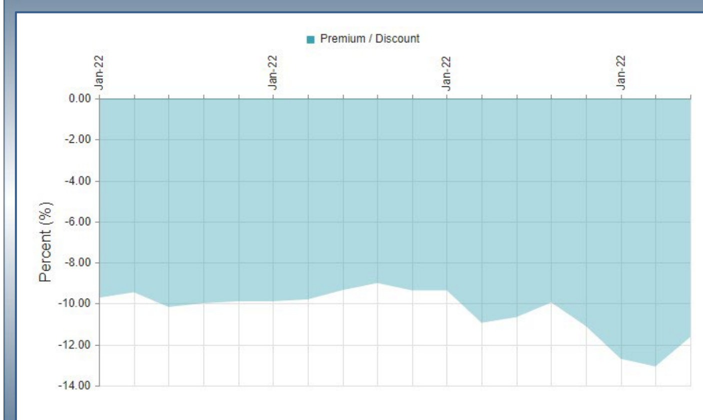

Figure 7

Well, VCIF is unlevered. That gives the portfolio yet an additional layer of safety.

I mentioned that VCIF traded at 88 cents on the dollar. Let's dig deeper into that.

Closed-end funds (CEFs) are a type of mutual fund, but they are very different than the open-ended type you might find in your 401(k) plan. In an open-ended fund, you actually send cash to the manager, who then uses it to buy new assets. Mutual funds *always* trade at their liquidation value.

Well, closed-end funds *don't*. They trade like stocks on the exchange and have a limited number of shares. If you want to buy some, you don't send the manager money. You buy the shares via your broker, the same way you'd buy a share of Apple or Microsoft.

Because of this, CEFs can trade at wild discounts or premiums to their underlying net asset value.

Toda, we can buy shares of VCIF at a 12% discount to NAV. And remember, VCIF purchases its loans at a nearly 13% discount to the face value. So, by the time we get access, we're getting a 12% discount on top of the original 13% discount.

This helps to explain why the fund is able to pay such a competitive yield.

Not all of VCIF's dividend is pure income. It's not uncommon for part of the dividend to be a return of capital, which partly explains why the stock's net asset value has trended slightly lower over the last year. I'd ok with that. There's nothing necessarily wrong with a fund paying out a return of capital so long as you understand that going into it.

So, what kind of returns can we expect here?

Before we answer that, we have to elaborate what we expect from the bond market. The consensus view here is that longer-term yields "have" to go higher because the Fed has scaled back its bnd buying program. Without the Fed aggressively buying, demand will be lower, which depresses prices and causes yields to rise.

While that makes intuitive sense, that view fails to take into account the economic effects of the Fed scaling back its stimulus. Lower growth and less optimism among investors should cause bond yields to fall rather than rise.

Furthermore, the growth trade appears to be dead for now. It's still early, but if the stock bubble really has burst, then investor will likely continue to dump growth stock names and replace them with value and income plays. And given that VCIF yields over 9%, there's a lot of wiggle room. Even if I've wrong and bond yields go higher, they'd have to go a *lot* higher to be competitive with VCIF's yield.

Between the current yield, a potential closing in the discount to net asset value and any appreciation in the value of the mortgages themselves, I believe returns of 20% to 30% over the next 1-2 years is very likely. Suffice it to say, I don't see a return like that in the broader stock market.

So, let's do it.

Action to take: Buy shares of the **Vertical Capital Income Fund (NYSE: VCIF). Set an initial stop loss at $8.95 based on closing prices.**

Note that VCIF is a small fund with only $103 million in assets and average trading volume of about 20,000 shares per day.

I don't expect the buying by my readers to move the price, but it might. So please be careful entering this position. Check the price before you buy, and if you see that the shares have jumped

Stock	Ticker	Entry Date	Buy Price	Recent Price	Stop Loss	Yield	Cumulative Dividends	Total Return	IRA Friendly?
Prologis	PLD	10/29/2021	$ 146.67	$ 147.33	None	1.75%	$ -	0.45%	Yes
Crown Castle International	CCI	10/29/2021	$ 181.90	$ 172.32	None	3.27%	$ -	-5.27%	Yes
Philip Morris International	PM	3/30/2021	$ 89.35	$ 102.04	None	5.27%	$ 1.20	15.55%	Yes
Altria Group	MO	3/19/2020	$ 37.10	$ 49.85	None	7.58%	$ 5.12	48.15%	Yes
Realty Income	O	3/19/2020	$ 48.08	$ 67.21	None	3.86%	$ 3.75	47.58%	Yes
AT&T	T	3/19/2020	$ 31.15	$ 24.12	None	8.30%	$ 3.64	-10.90%	Yes
Enterprise Products Partners	EPD	3/19/2020	$ 14.52	$ 23.70	None	7.42%	$ 2.24	78.62%	No
Kinder Morgan	KMI	3/19/2020	$ 11.20	$ 17.19	None	6.24%	$ 1.32	65.29%	Yes
Ventas	VTR	3/19/2020	$ 19.98	$ 50.60	None	3.28%	$ 3.04	168.48%	Yes
Public Storage	PSA	3/19/2020	$ 187.60	$ 341.79	None	2.48%	$ 10.00	87.52%	Yes
International Paper	IP	3/19/2020	$ 30.13	$ 45.49	None	3.69%	$ 2.57	59.49%	Yes
STAG Industrial	STAG	3/19/2020	$ 21.71	$ 39.82	None	3.32%	$ 1.93	92.29%	Yes
Retail Opportunity Investments	ROIC	3/19/2020	$ 7.25	$ 18.05	None	2.47%	$ 0.42	154.76%	Yes

aggressively, wait a day or two before buying.

Update on the Forever Portfolio

The notion of holding a portfolio "forever" is simultaneously soothing and terrifying in a market like this.

Most of the stocks in this list were purchased at the pits of the COVID-19 bear market. By coincidence – I am the first to admit I'm not a market timer – I came very close to picking the bottom in the original 10 stocks. It was scary to buy then. It really felt like the world was ending. But it was the right move, and now we see the results. Apart from AT&T, which has a host of management issues we'll have to save for another day, every other stock in that original 10 has enjoyed a nice run. We're also up in two of our three more recent additions, and this despite the market being in freefall.

I'm not going to recommend at new additions today to the Forever Portfolio. There's just nothing I see at the moment that is compelling enough to make me take the plunge. But we could get there. It's unclear for the moment whether this spate of volatility is a correction that will pass or the start of something worse. In either event, I do think it's likely we see some really good bargains in the months ahead. Just as stocks became irrationally expensive on the upside, they will likely become irrationally cheap on the downside. And that's when we'll back up the truck.

In the meantime… keep a little extra cash on hand and be willing to stay nimble.

If you do have cash burning a hole in your pocket and want to put something to work, I still really like our energy holdings. If you don't already own shares, I'd recommend picking up shares of **Enterprise Products Partners (NYSE: EPD)** and **Kinder Morgan (NYSE: KMI**) from the Forever Portfolio and **Energy Transfer (NYSE: ET)** from our main portfolio. We're already up 17% in Energy Transfer, even after the most horrid of months in the market.

And speaking of the market…

I'll reiterate my comments from earlier one last time for emphasis. We don't *know* what direction the market will go. We don't know if this is a garden variety correction or the start of a major bear market. But we do know that stocks are expensive and we're fighting the Fed.

Does it make sense to sell a good dividend payer and potentially pay capital gains taxes in order to try and buy a dip later?

Probably not.

Does it make sense to cut losses in a more speculative investment and conserve cash?

Probably.

If nothing else, please review your portfolio and look at your position sizes. Make sure that you don't have any positions that are so big as to create the possibility for major loss.

Losses are part of investing. We're able to earn returns precisely because we're willing to risk loss. But the best way to keep losses containable is to limit your exposure to any single strategy to a level that makes sense. Ray Dalio, founder of the world's largest hedge fund Bridgewater, made a career out of this simple concept. It's the basis for his risk parity portfolios. Dalio sets position sizes based on the volatility of each position. High-vol positions have less exposure and low-vol position have greater exposure.

Dalio still takes losses. We all do. But his are containable. When something goes wrong, as it inevitably does, it doesn't tank his entire portfolio.

That's going to wrap it up for now. We'll hope February is a better month… but we'll be prepared if it isn't.

Until next time, 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
Vertical Capital Income Fund	VCIF	1/27/2022	$9.99	$9.99	$8.95	9.23%	$ -	0.00%	Yes	Buy
Energy Transfer Partners	ET	12/27/2021	$8.16	$9.60	$7.30	7.42%	$ -	17.65%	No	Buy
EPR Properties	EPR	11/29/2021	$47.78	$42.56	$33.92	6.28%	$ -	-10.93%	Yes	Buy
Chevron Corporation	CVX	9/30/2021	$103.33	$135.37	$88.14	4.62%	$ 1.34	32.30%	Yes	Buy
Nuveen Real Estate Income	JRS	6/25/2021	$10.77	$10.94	$9.69	6.68%	$ 0.19	3.34%	Yes	Buy
ClearBridge Energy Midstream Opportunity	EMO	5/26/2021	$21.94	$24.31	$17.30	7.10%	$ 0.76	14.27%	Yes	Buy
First Trust Dynamic Europe Equity Income	FDEU	5/26/2021	$13.68	$13.36	$11.76	5.29%	$ 0.36	0.29%	Yes	Buy
Magellan Midstream Partners	MMP	1/29/2021	$44.41	$48.19	$41.78	8.65%	$ 4.12	17.79%	No	Buy
WisdomTree Emerging Markets High Dividend Fund	DEM	12/31/2020	$41.22	$44.49	$40.42	4.48%	$ 1.81	12.31%	Yes	Buy
Healthcare Trust of America	HTA	11/20/2020	$26.80	$31.70	$26.95	4.61%	$ 1.29	23.08%	Yes	Buy
Physicians Realty Trust	DOC	11/20/2020	$17.80	$17.64	$15.30	4.49%	$ 0.92	4.27%	Yes	Buy
AllianceBernstein Holding, LP	AB	11/6/2020	$30.85	$46.21	$40.98	6.77%	$ 3.58	61.39%	No	Hold
Main Street Capital	MAIN	9/25/2020	$29.74	$42.82	$35.50	5.93%	$ 2.88	53.67%	Yes	Buy
Iron Mountain	IRM	8/25/2020	$30.22	$43.66	$39.74	5.30%	$ 3.10	54.72%	Yes	Hold
Starwood Property Trust	STWD	8/25/2020	$15.70	$24.02	$18.15	7.38%	$ 2.40	68.28%	Yes	Buy
Dow Inc.	DOW	6/24/2020	$38.45	$60.18	$47.65	4.53%	$ 3.50	65.62%	Yes	Buy
Ecofin Sustainable and Social Impact Term Fund	TEAF	6/24/2020	$10.73	$15.05	$12.35	6.14%	$ 1.20	51.44%	Yes	Buy
LyondellBasell Industries	LYB	5/22/2020	$60.39	$95.85	$79.23	4.27%	$ 6.46	69.42%	Yes	Buy
Ares Capital Corporation	ARCC	4/23/2020	$11.35	$21.92	$17.55	8.20%	$ 2.41	114.36%	Yes	Buy