The Sizemore Income Letter

May 2022

Time for a Bear Market Rally?

By Charles Lewis Sizemore, CFA

If you're in a hurry, I can answer the question in the headline with a single word: Yes!

After brutal declines in April and most of May, it looks like we may be due for a bear market rally.

It is also *possible* that this is more than that. This could be the start of a new bull market. We can't rule that out. But given that we're still fighting the Fed, inflation continues to be a threat, and the economy is still going through a post-pandemic realignment, I'm going to operate under the assumption that this is a bear market rally.

That's just fine. We can work with that! But the takeaway is that this is likely a good opportunity to *trade* rather than to make major new buy and hold positions. There are exceptions, of course. As I've been writing for the past two months, I believe that the pricing in some of the really beaten-down tech stocks is finally low enough to make the sector investable again. (I named PayPal and Netflix as specific examples, but there are plenty more where that came from.)

But even here, I recommend being very selective and averaging in.

Remember, stocks weren't exactly cheap before the pandemic. By late 2019, valuations had already started to look at little stretched. The correction in 2018 knocked prices down a notch, but that wasn't a deep enough correction to really reset the clock.

Well, in the 2022 bear market, the S&P 500 has been knocked back to

Figure 1

March 2021 levels. That's March *2021*, not March 2020. The S&P 500 would need to drop another 20% just to get back to the already-expensive levels in place immediately before the pandemic.

Will we get there?

I don't know. We can never know with any degree of certainty until after the fact. But I certainly think we can. And if we do, then I'd consider that a very decent buying opportunity for long-term money.

If we *don't* get there, prices firm up, and we instead start a new bull market, I would be reluctant to put real money into it.

And here's why…

Take a good look at Figure 2. This takes the Cyclically-Adjusted Price/Earnings Ratio of the S&P 500 over the past 30 years. (In case you need a refresher, this is a broad market valuation tool that compares today's prices to a 10-year average of earnings as a way of smoothing out the booms and busts of the economic cycle.)

I chose 30 years for a reason. That's a long enough window to include the 1990s tech mania and the bear markets of 2000-2002 and 2008. This is really when the era of central bank experimentation started. The extreme actions taken by the Federal Reserve during and after the onset of the pandemic were really just the latest and biggest in a long string of interventions that started in the mid-1990s under then-Chairman Alan Greenspan.

Cyclically-Adjusted Price/Earnings Ratio

Figure 2

I'm really not all that interested in what stock prices looked like in the 1870s or even the 1970s. That was a different financial regime that's not particularly relevant today.

Limiting the data to the Fed-driven markets of the past three decades makes today's pricing look less extreme than it would be had I included data going back to the 1800s. A *lot* less extreme, in fact. But it still shows a market that is expensive even by the standards of a period known for bubbles.

After the tumble the S&P 500 has taken this year, prices have just barely dipped into the upper range of normal.

This is to say that prices no longer look insane. But they are still a long way from being "cheap."

The data I pulled comes from research site GuruFocus. Now, take this next part with a grain of salt, but based historical precedent, were stocks to simply revert to their long-term average valuations from here, we'd be looking at annualized returns of about 1.9% per year over the better part of the next decade.

I don't for a minute expect stock returns to come in at exactly 1.9% over the coming years. Real results could be wildly higher or lower, and it's a mistake to get fixated on the specific forecast here. The takeaway is simply that, at current levels, stocks are not priced to deliver high long-term returns.

So, again, I think we're set up very nicely for a bear market rally here. But we are still a long way from a generational buying opportunity.

2022 Bear Market Plan

Let's review my 2022 Bear Market Plan.

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 3

Prospect Capital (NYSE: PSEC)

Figure 4

I've been repeating myself for months now, but this is important and is worth repeating again.

The first bullet point is to keep more cash on hand… and the last bullet point was to "be willing to make short-term trades."

Well, the situation we have today is exactly why both of those bullet points made the list. We keep extra cash on hand so that we have dry powder to put to work when the opportunities present themselves. And that's exactly what a bear market rally is. This is a good time to put that cash to work, or at least some of it.

As for the rest of the list, my advice hasn't changed. It still makes sense to keep your position sizes modest. We've seen enough stocks blow up this year that I don't really feel the need to explain why. And I still believe that keeping at least part of your allocation invested in non-market alternatives makes sense. (I can help with that, by the way. Just reach out, and we can talk.)

And as for those dividend payers… well, I have a new one to add this month!

Buying a Dollar for 72 Cents

This month, I recommend you take a look at business development company (BDC) **Prospect Capital (NYSE: PSEC)**.

If you've been reading for any length of time, you know I'm a fan of BDCs. Ares Capital Corporation (NYSE: ARCC) was one of my very first recommendations in the *Sizemore Income Letter*, and we're up over 100% including dividends. I added Main Street Capital (NYSE: MAIN) later in 2020, and we're up a good 42%.

I consider Ares and Main Street to be two of the absolute best in class and both remain buys.

Let's get back to Prospect Capital. PSEC's shares haven't done a whole lot in recent years. The price is hovering near mid-2017 levels. But while the shares have been treading water, Prospect's book value – the value of its interests in the businesses it owns – has been steadily ticking higher (Figure 5).

Today, Prospect's shares trade for just 72% of book value. In plain English, that means that you could hypothetically buy up the entire company and sell it for spare parts and still walk away with a profit of nearly 30%.

Prospect Capital Book Value

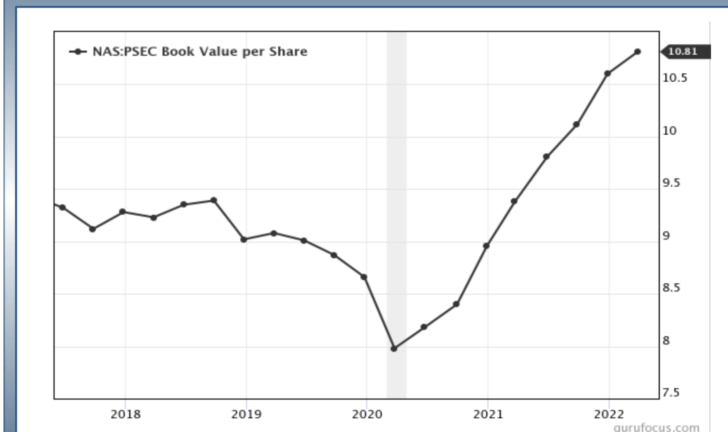

Figure 5

Prospect Capital Price/Book

Figure 6

I have a rule of thumb with Prospect Capital. I tend to avoid it when it trades above or near book value. But when the discount blows out to 20% or more, I get interested. The way I see it, even if book value ends up being inflated (i.e. the value of PSEC's portfolio is overstated), I still have a wide margin of safety. When you buy a dollar's worth of assets for 72 cents, a lot can go wrong and you'd still be getting a deal.

You have to be patient, of course. There is no ironclad law of the universe that says that a BDC "has" to trade at book value, and PSEC has gone years trading a discount. But given enough time, prices always seem to revert close to book value, and as recently as last year the shares nearly reached parity.

I'm willing to be patient here because I'm being paid handsomely for my time. At current prices, PSEC sports a dividend yield of 9.2%.

Can dividend cuts happen? Sure they can. PSEC has been forced to reduce its payout in the past when it hit a rough patch. But it's worth noting that PSEC has managed to keep its payout at current levels for years, even surviving the worst of the pandemic with it intact.

And again, it comes back to margin of safety. With a discount to book value of nearly 30% and a dividend yield approaching double digits, a lot can go wrong before a long-term investor would have to worry about significant loss.

Let's dig a little deeper into the details.

BDCs are as close to Main Street as Wall Street gets. They tend to own debt and equity positions in companies that are a little too big for a local bank loan but not quite big enough to access the capital markets through an IPO or a bond offering. These are middle market companies.

The smaller size can make them a little more sensitive to the bends and twists of the economic cycle. But that's just fine. PSEC mitigates this risk by maintaining a diversified portfolio. Apart from a large 18% allocation to real estate, its sector exposure isn't particularly overweighted in any other industry. PSEC owns a

Prospect Capital Dividend Yield

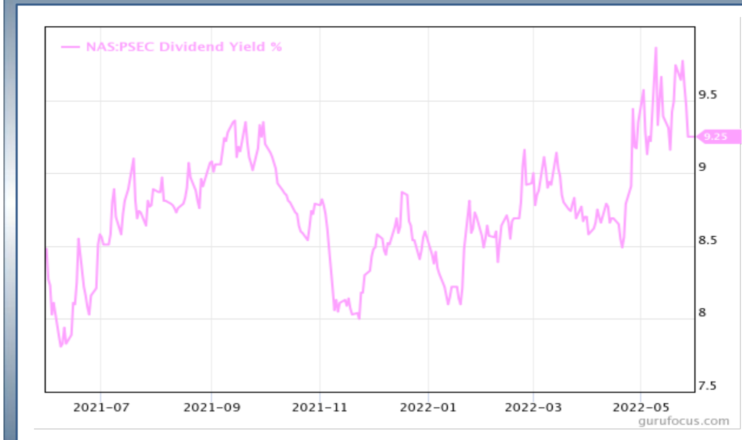

Figure 7

Portfolio Breakdown

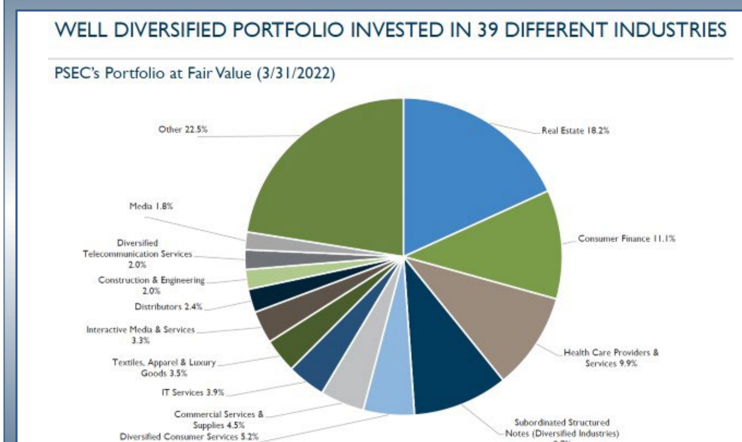

Figure 8

Inside Ownership

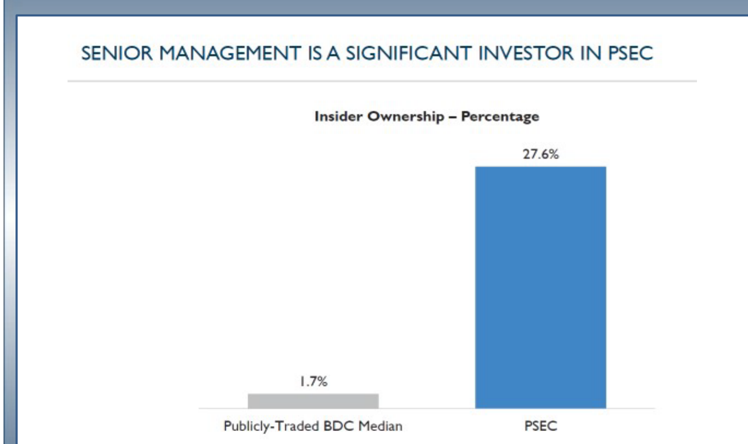

Figure 9

diverse collection of investments that should be able to weather whatever comes next in the economy.

Management Eats its Own Cooking

I like to see decisionmakers with skin in the game. One of the most unfortunate byproducts of the modern economy is the "heads I win, tails you lose" mentality that tends to dominate large companies. If management rolls the dice and take massive risk that happen to pan out, great! They get rewarded with bonuses and stock options.

But if they bet big and lose, there are no real consequences for them. They lost *your* money, not their own. And they can go get another high paying job tomorrow.

Well, that's not at all the case with Prospect Capital. Management owns over a quarter of the shares outstanding and regularly buys more on the open market.

I should be clear here that these are not executive stock options or an egregious case of the executives enriching themselves at the expense of the shareholders. Management bought the shares the same way you or I would. They used their own money and bought the shares for their own accounts.

I like that. It shows commitment and it tells me that management is in this for the long haul.

So, what kind of returns should we expect here?

Let's say that book value rises another 2-5%, in line with recent growth, and that the discount to book value gets slashed in half from the currently ridiculous 28% to a less ridiculous (but still high) 14%. And then let's add in a year's worth of dividends at 9%.

Adding those together gets us a conservative return of 25% to 30% in roughly a year. And obviously, the returns could be a lot better than that if book value rises more aggressively and the discount narrows further.

And if I'm wrong?

It's hard to see much downside. We simply collect the dividend until we hit our stop loss. I'm recommending a stop loss about 12% from current prices, so it's hard to see a scenario where we lose much money here.

One Last Bonus

I would be remiss if I didn't mention that Prospect Capital pays its dividend monthly rather than quarterly.

Now, I would never recommend a stock simply because it paid its dividend monthly. That would be ludicrous. But all the same, it's a nice bonus. Our expenses come monthly, and its nice when our inflows match.

So, with no further ado, please take the following action:

Action to take: Buy shares of Prospect Capital (NYSE: PSEC) at market. Set an initial stop loss at $6.80 based on closing prices.

Portfolio Review

We're running a leaner portfolio these days. The bear market caused several of our stop losses to get tripped.

That's ok. It means that the stocks remaining in the portfolio are what's working, even in a bear market.

Energy continues to be a strong performer for us. We're up a quick 2% in Oneok (NYSE: OKE), which I added last month, and nearly 45% in Energy Transfer (NYSE: ET).

Chevron (NYSE: CVX) is looking even better, up 75%. ClearBridge Energy Midstream Opportunity Fund (NYSE: EMO) and Magellan Midstream (NYSE: MMP) are up 41% and 26%, respectively.

I still believe there is a lot more upside in all of these. After years of shunning energy stocks, investors have finally warmed up to them again, and I don't expect that to change in the immediate future. Energy stocks are cheap and pay some of the highest dividends available in the market today.

So, if you don't already own these, it's not too late.

I'm optimistic this month. I really believe we have at least a few weeks of really solid gains in front of us. But we can't get complacent. Until the market proves me otherwise, I believe we're still in a bear market. We treat this as a bear market rally for now.

So, enjoy the gains, but be ready to take profits or cut losses if things start to get dicey again!

That's all I have for now.

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
Prospect Capital	PSEC	5/31/2022	$7.78	$7.78	$6.80	9.25%	$ -	0.00%	Yes	Buy
ONEOK, Inc.	OKE	4/28/222	$65.50	$67.05	$47.91	5.73%	$ -	2.37%	Yes	Buy
Digital Realty Trust	DLR	3/24/2022	$136.79	$141.51	$118.15	3.57%	$ -	3.45%	Yes	Buy
Vertical Capital Income Fund	VCIF	1/27/2022	$9.99	$9.59	$8.95	9.23%	$ 0.07	-3.25%	Yes	Buy
Energy Transfer Partners	ET	12/27/2021	$8.16	$11.65	$7.79	7.42%	$ 0.18	44.91%	No	Buy
EPR Properties	EPR	11/29/2021	$47.78	$50.77	$33.92	6.28%	$ 1.00	8.35%	Yes	Buy
Chevron Corporation	CVX	9/30/2021	$103.33	$178.28	$130.77	4.62%	$ 2.76	75.21%	Yes	Buy
ClearBridge Energy Midstream Opportunity	EMO	5/26/2021	$21.94	$30.12	$20.49	7.10%	$ 0.76	40.75%	Yes	Buy
Magellan Midstream Partners	MMP	1/29/2021	$44.41	$50.94	$41.78	8.65%	$ 5.16	26.32%	No	Buy
Healthcare Trust of America	HTA	11/20/2020	$26.80	$29.68	$26.95	4.61%	$ 1.61	16.75%	Yes	Buy
Physicians Realty Trust	DOC	11/20/2020	$17.80	$18.57	$15.30	4.49%	$ 1.15	10.79%	Yes	Buy
Main Street Capital	MAIN	9/25/2020	$29.74	$38.43	$35.50	5.93%	$ 3.91	42.37%	Yes	Buy
Iron Mountain	IRM	8/25/2020	$30.22	$54.94	$42.57	5.30%	$ 4.33	96.14%	Yes	Hold
Starwood Property Trust	STWD	8/25/2020	$15.70	$23.93	$18.15	7.38%	$ 2.88	70.76%	Yes	Buy
Dow Inc.	DOW	6/24/2020	$38.45	$69.06	$48.78	4.53%	$ 4.90	92.35%	Yes	Buy
Ecofin Sustainable and Social Impact Term Fund	TEAF	6/24/2020	$10.73	$14.72	$12.53	6.14%	$ 1.61	52.14%	Yes	Buy
LyondellBasell Industries	LYB	5/22/2020	$60.39	$117.08	$79.23	4.27%	$ 8.72	108.31%	Yes	Buy
Ares Capital Corporation	ARCC	4/23/2020	$11.35	$19.87	$17.94	8.20%	$ 2.85	100.18%	Yes	Buy