The Sizemore Income Letter

Early August 2022

Playing the Long Game

By Charles Lewis Sizemore, CFA

As I mentioned in my last update, I had to move the publication schedule this month due to a travel mishap. Rather than having the standard July and August issues, we will instead have an early August and a late August issue.

And about that travel mishap…

New York is a lovely city to visit. Every time I go, I have a good time. There's a lot of energy there… a feeling like people are *going* somewhere. It's fast… and it's energizing. And despite the stereotype about New Yorkers being rude, I've always found them to be almost ridiculously friendly and helpful. No matter how busy they are in the bustle of the city, every New Yorker I've ever spoken to – from the humble street cleaner to the master of the universe in a power suit – seemed to have at least a few seconds to answer one of my idiotic touristic questions or simply point me in the right direction. It's a refreshing dose of humanity in a place world renown for being cutthroat.

But while I love visiting New York, I'm not a fan of getting stranded there.

I'm not one to advocate violence. But if I were hypothetically to kneecap the entire board of directors of JetBlue with a tire iron, I don't know that any jury would convict me. They might even try to award me damages.

Future MBA classes will study the travel mishaps of the summer of 2022 as a lesson for how not to run a business. It turns out that laying off huge swaths of your workforce and then returning to full capacity quickly thereafter with a skeleton crew was a bad idea. Who knew!

But more fundamentally, it exposes the flaws of an overoptimized system. When there is no slack in the system – no margin for error – small mishaps snowball into catastrophes. A little bad weather or a pilot calling in sick can throw the entire operation into chaos.

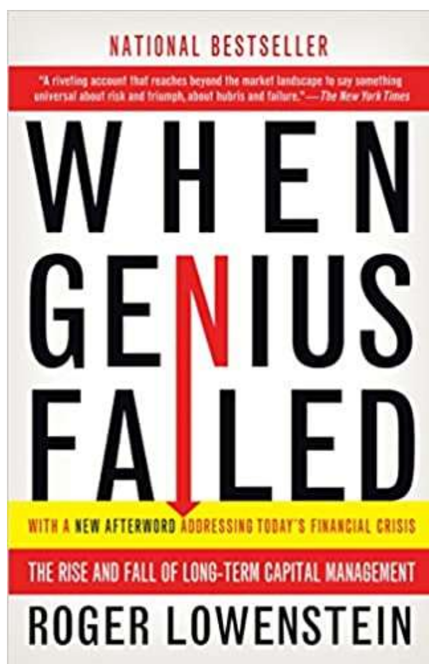
In my case, my flight was delayed by an hour… then two… then three… and then cancelled altogether because the pilots timed out and were no longer able to fly… and there were no replacement pilots. The airline rebooked me… for a flight several days later. But thankfully I was able to buy a ticket with American Airlines sooner and put the ordeal behind me. Because there were no hotels to be found in NY, and having to

camp out in the airport for days would have likely resulted in me killing a lot of people with my bare hands.

At any rate, there are lessons to learn from this. The first being to NEVER fly JetBlue. Pay the additional cost to fly a real airline or simply stay at home.

But apart from that, we should always have a margin of safety in place. If you invest in such a way that even a small expected event can lead to devasting losses… frankly, you're doing it wrong. That unexpected event will eventually happen, and it will kill you.

If you need an example, read the book *When Genius Failed*. It's the definitive account of the failure of the hedge fund Long-Term Capital Management, and if I were designing an MBA program, I would make it required reading.



Long-Term Capital Management was no ordinary hedge fund. It was an all-star team of the brightest minds of both Wall Street *and* financial academia. The portfolio managers were the guys that quite literally wrote the textbooks I had to study in grad school. To use a sports analogy, this was the 1927 Yankees (the one with Babe Ruth and Lou Gehrig) or the 1992 Dream Team (the Olympic basketball team that had Michael Jordan, Magic Johnson and Larry Bird all on the same team). They were THAT good.

And yet they blew up in spectacular fortune, losing substantially the entire value of the fund and nearly taking down the global financial system.

Why?

It's simple. They thought they had built the perfect trading model, and so they leveraged it up… to the tune of about 27 to 1.

With that much money borrowed, there was no margin for error. Even a modest loss could wipe them out.

And that's what happened. Russia defaulted on its debts, causing a ripple effect in emerging market bonds that quickly ate through LTCM's equity, leaving them illiquid and insolvent.

I've made plenty of mistakes as an investor, but I've never blown up. I've never taken catastrophic losses that I can't recover from.

I won't say that day will never come because I'm just superstitious enough not to tempt fate. But I can tell you that I consider it very unlikely that I'll ever blow up because I manage my risk and I maintain that all important margin of safety.

All About Risk Management

Before I get to this month's recommendation, you're going to have to tolerate a diatribe on risk management.

But hear me out because the lesson from this will ultimately be far more valuable than any single stock pick.

I'm going to go point by point on how I personally reduce risk. I can never reduce risk to zero, as that would mean reducing my returns to effectively zero. But I at least keep my risk to tolerable levels.

Position Sizing

It starts with position sizing. The easiest way to make a great stock a terrible stock is to simply own too much of it. The larger your position, the more risk you take.

I once had a large position go to zero on me. I remember it well… Thornburg Mortgage. It was a superprime lender. That's *super*prime, not subprime… as in *better than* prime. It was a solid mortgage lender that lent to ultrarich homeowners. And then the 2008 meltdown happened, and the market seized up.

I averaged down again and again… because I knew the company's financials inside and out and knew them to be fundamentally sound. But what I didn't account for was the possibility that their lenders would simply freak out and call in their loans, forcing the lender to sell illiquid mortgages into a market with no buyers.

Lesson learned.

Thornburg was a large position for me at the time, making up more than 10% of my portfolio. Having it go to zero stung… badly. Ever since, I've had a general policy of never having more than 3-5% of my portfolio in any single stock. I'll go higher than that in an ETF or mutual fund, and I'll allow a stock to grow larger than 5% due to portfolio appreciation. Let your winners run, after all! But at the initiation of the trade, I limit it to 3-5%. And I sleep well at night.

Stop Losses

As you know, I usually include stop loss guidance on the stocks in the Sizemore Income Letter. The only exceptions are the "Forever" stocks.

Selling is harder than buying. Finding a good stock is relatively easy if you enjoy reading and researching. But knowing when to cut it loose is hard. You're always going to face the conflicting impulses to sell too early on the way up and too late on the way down.

That's where stop losses can really help. They give you rules, and if you follow those rules you can ensure that your losses remain the small and tolerable kind and not the catastrophic and hard-to-recover-from type.

I could write a tome on the science of setting the proper stop, but for now, we'll just leave it here. Having stops is an important plank in a risk management strategy.

Buy at a Reasonable Price

I gave up on "pure" value investing years ago. I went through the same evolution as Warren Buffett. Like Buffett, I realized that cheap stocks are often cheap for a reason. They might be good for a trade, but they are often lousy long-term investments because they are often companies with deep issues or a difficult industry environment.

To quote Buffett, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

This doesn't mean we should ignore prices altogether. Grossly overpaying is

a recipe for lousy returns. But ultimately, high quality is likely to beat cheap pricing over the life of a long-term investment. Simply keeping this in mind helps me to avoid value traps and is an important, if somewhat subject, element of risk management.

Consider Macro and Industry Trends

The two dumbest mistakes I ever made as an investor somehow both involved Apple (Nasdaq: AAPL). Both seem utterly idiotic in hindsight, but that's true of most mistakes, alas…

My first mistake was failing to see Apple as a "phone company" rather than as a computer company that also sold phones. After watching the PC obliterate the Mac throughout the 80s and 90s, I just couldn't get it through my thick skull that computers no longer mattered. And as a result, I missed out on buying Apple before one of the most epic runs in the history of the stock market.

My other mistake was failing to see that the iPhone would obliterate the BlackBerry. BlackBerry was a classic value trap that I walked right into. It looked cheap on paper, and BlackBerry devices were "everywhere." Every executive carried one. They had better security than iPhones and played better with corporate IT departments.

I just couldn't see what should have been patently obvious, which is that iPhones would only get better and that, eventually, corporate IT departments would get comfortable with them. So in addition to failing to enjoy gains in Apple, I also took outright losses in BlackBerry.

Dumb.

Had I been more open minded about industry trends, I would have seen what, in retrospect, was obvious.

But you can go higher level here too. Having just gotten back from New York and seeing the two large fountains where the twin towers used to be, I think back to how much 9/11 changed the macro landscape. That event put the U.S. on course for what would become two decades of war. That event defined the period.

We just had another one of those events in the Russian invasion of Ukraine. The world is different now. This is Cold War 2.0. The West and Russia are in the process of disentangling their economies.

Europe – which has been FAR more aggressive than the US in trying to replace oil and gas with renewable energy – is now bringing coal-fired plants back online. Removing dependence on Russian gas is important enough to Europe to tolerate drastically higher fuel costs AND go backwards on their environmental commitments for the foreseeable future. This is the post-Ukraine-Invasion world.

It's important to understand this environment. Investors that do will prosper. Those that don't won't.

A Russia-Proof New Addition

This brings me to our new portfolio addition. The war in Ukraine is in something of a stalemate. As bad as the situation is for the people of Ukraine, the likelihood that this escalates into a broader war or destabilizes Europe gets lower by the day.

That said, things will not be going back to normal anytime soon. There is no

realistic possibility of rapprochement with Russia any time soon. We're looking at another iron curtain. Russia and the West are going their separate ways.

Battleships do not turn on dimes. It will take Europe years to replace Russian gas with new sources and to build out the infrastructure. This creates fantastic tailwinds for exporters of liquified natural gas (LNG).

LNG is exactly what it sounds like. Natural gas can be cooled into a liquid form to facilitate transportation in ships. Upon reaching its destination, the liquified natural gas is re-gassified and then piped into the system. It's less efficient than simply moving gas from point A to point B via a pipeline. But in situations where pipelines aren't feasible – such as crossing the oceans – it works!

As it turns out, the United States is a major exporter of LNG… and as of this year, the largest in the world. And we're now sending a lot more of it to Europe to replace Russian gas.

Back in March, the Biden Administration promised to export an additional 15 billion cubic meters of LNG to Europe.

No one believed it was possible. Until it happened. Through the first six months of the year, the US had already sent more LNG to Europe than in all of 2021. And there's a lot more coming. Even when the massive increase in US exports, Europe is facing a major energy shortage with no easy solution in sight.

So, suffice it to say that producing and exporting LNG to Europe is likely to be a wildly profitable business for years to come.

And so with that, let me introduce you to **Cheniere Energy Partners LP (NYSE: CQP)**.

Cheniere Energy Partners is a sister company of **Cheniere Energy, Inc (NYSE: LNG)**. As you can tell by the ticker symbol, Cheniere is all about LNG. It's the largest LNG producers in the United States and the second largest in the world.

Figure 1

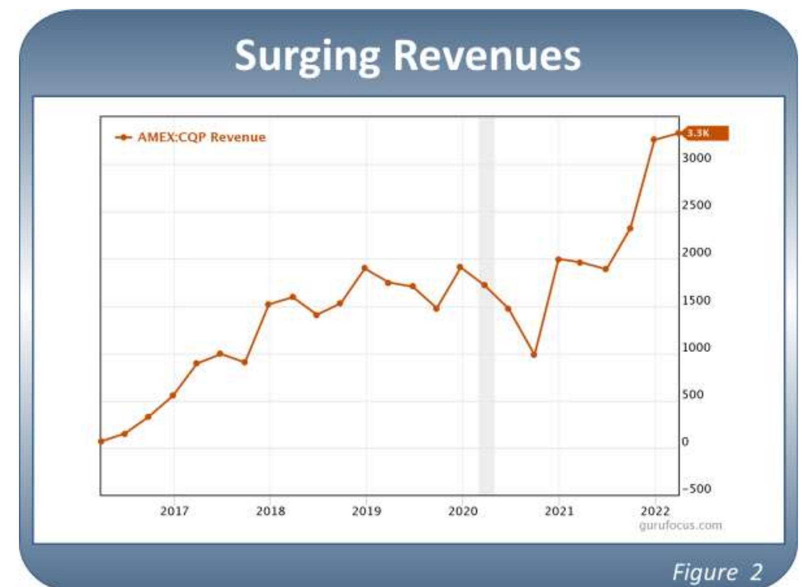


Figure 2

Cheniere operates (and is busy expanding) LNG facilities on the U.S. Gulf Coast that process billions of cubic feet of natural gas per day into LNG and load the liquid energy onto insulated ships.

Cheniere's Sabine Pass facility in Louisiana opened in 2016 and currently has six fully operational liquefaction units, or "trains." The production capacity of all six trains is approximately 30 million tons per year of LNG. The company's LNG facility in Corpus Christi, Texas is no slouch either. Its three trains produce 15 million tons per year of LNG.

It's a simple business at its core. The company purchases natural gas from North American gas market, which is piped in. It processes the natural gas into LNG and then has it shipped to regasification facilities around the world.

If you're familiar with pipeline companies, you've probably heard the term "take or pay" before. 85% of Cheniere's production is sold under take or pay contracts, meaning that the company is paid based on volumes rather than price, and the volumes are effectively guaranteed.

This is good. We're betting that the volume of LNG exported abroad continues to explode here. We're not interested in making specific price forecasts.

Cheniere Energy, Inc. is a great growth stock, and I see a lot of upside in it over the coming years. But given that this is an income letter, I'm more interested in its sister partnership. Cheniere Energy Partners. I won't bore you with the details, but Cheniere Energy Inc and Cheniere Energy Partners work together and they are structured in such a way that "Inc" is designed to profit from the long-term growth of the business, whereas "Partners" is designed primarily to throw off tax-advantaged income.

That said, "Partners" hasn't exactly been a slouch on growth (see Figure 2 on previous page). Starting at zero in 2016, the company now brings in over $3 billion per quarter in revenue.

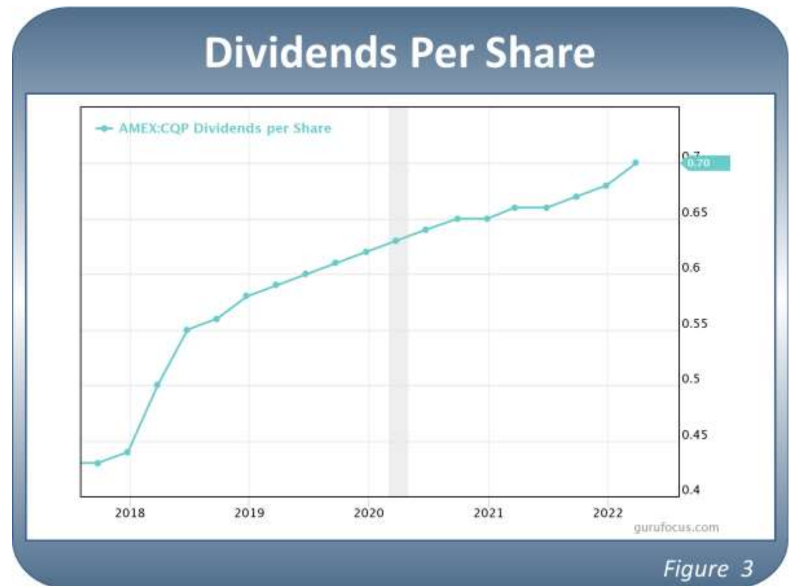


Figure 3

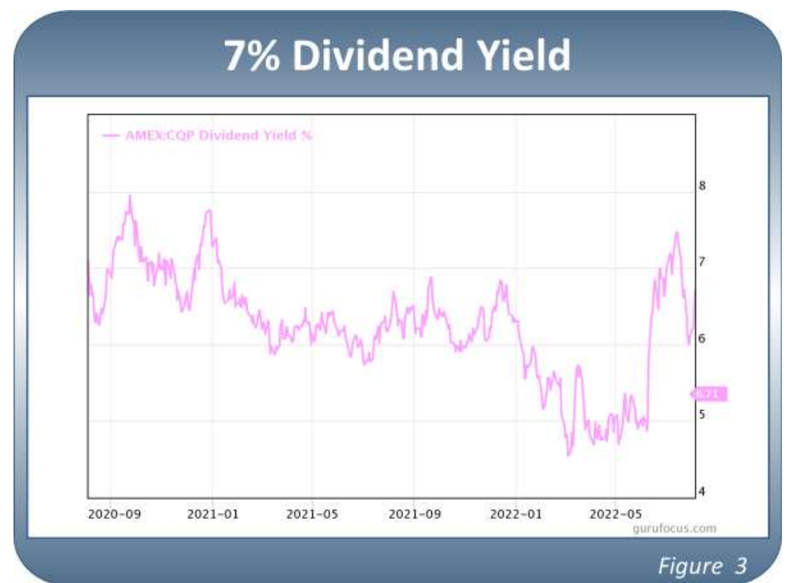


Figure 3

Those growing revenues have translated into growing dividends, as the company raises its dividend nearly every single quarter. The dividend has more than doubled since 2018, and the company was able to keep raising it throughout the chaos in the energy markets in 2020.

At today's prices, the shares yield just shy of 7%.

So, in Cheniere Energy Partners, we have a high and growing dividend supported by a trend – the boom in exported LNG – that is well supported and should be firmly in place for years.

Let's do it.

Action to take: Buy Cheniere Energy Partners (NYSE: CQP) at market. Set an initial stop loss at $33.01 based on closing prices.

Note that CQP is a publicly-traded partnership and can potentially create tax complications in retirement accounts. **CQP is not IRA friendly**, so please do not buy the stock in your IRA or 401(k) plan.

Portfolio Update

I have one important announcement to make. **Healthcare Trust of America (NYSE: HTA)** just recently merged with **Healthcare Realty Trust (NYSE: HR)**… and so HTA no longer exists.

I'm comfortable with the new entity. Their business model is essentially the same. They own quality medical office buildings and rent them out to doctors. It really is that simple.

In order to also keep our reporting simple, I'm going to close out the HTA trade in the books and start a new line for HR with the price on the day of the merger, July 20, as the entry date.

So, in our next update, you're see HTA replaced with a new HR. You won't need to take any action.

That's all I have for now. You'll be getting a "Late August" newsletter from me at the end of this month as well as the usual weekly updates. And then our publishing schedule should return to normal in September.

Have a good weekend, and 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
Cheniere Energy Partners	CQP	8/4/2022	$46.49	$46.49	$33.01	6.92%	$ -	0.00%	No	Buy
Citigroup Inc	C	6/23/2022	$47.34	$51.26	$32.57	4.39%	$ -	8.28%	Yes	Buy
ONEOK, Inc.	OKE	4/28/222	$65.50	$57.62	$47.91	5.73%	$ 0.94	-10.60%	Yes	Buy
Digital Realty Trust	DLR	3/24/2022	$136.79	$129.44	$118.15	3.57%	$ 1.22	-4.48%	Yes	Buy
Vertical Capital Income Fund	VCIF	1/27/2022	$9.99	$9.48	$8.95	9.23%	$ 0.37	-1.40%	Yes	Buy
Energy Transfer Partners	ET	12/27/2021	$8.16	$11.11	$7.79	7.42%	$ 0.38	40.75%	No	Buy
EPR Properties	EPR	11/29/2021	$47.78	$52.00	$33.92	6.28%	$ 1.83	12.65%	Yes	Buy
Chevron Corporation	CVX	9/30/2021	$103.33	$151.12	$130.77	4.62%	$ 4.18	50.30%	Yes	Buy
ClearBridge Energy Midstream Opportunity	EMO	5/26/2021	$21.94	$26.79	$20.49	7.10%	$ 1.65	29.63%	Yes	Buy
Magellan Midstream Partners	MMP	1/29/2021	$44.41	$49.91	$41.78	8.65%	$ 6.20	26.34%	No	Buy
Healthcare Trust of America	**HTA**	**11/20/2020**	**$26.80**	**$25.22**	**$26.95**	**4.61%**	**$ 6.76**	**19.31%**	**Yes**	*
Physicians Realty Trust	DOC	11/20/2020	$17.80	$17.42	$15.30	4.49%	$ 1.38	5.62%	Yes	Buy
Main Street Capital	MAIN	9/25/2020	$29.74	$44.33	$35.50	5.93%	$ 4.63	64.63%	Yes	Buy
Iron Mountain	IRM	8/25/2020	$30.22	$48.95	$42.57	5.30%	$ 4.95	78.37%	Yes	Hold
Starwood Property Trust	STWD	8/25/2020	$15.70	$23.57	$18.15	7.38%	$ 3.36	71.53%	Yes	Buy
Dow Inc.	DOW	6/24/2020	$38.45	$50.99	$48.78	4.53%	$ 5.60	47.18%	Yes	Buy
Ecofin Sustainable and Social Impact Term Fund	TEAF	6/24/2020	$10.73	$14.83	$12.53	6.14%	$ 1.79	54.85%	Yes	Buy
LyondellBasell Industries	LYB	5/22/2020	$60.39	$85.50	$79.23	4.27%	$ 15.11	66.60%	Yes	Buy
* Position moved to HR										

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