The Sizemore Income Letter

September 2022

How Low Does it Go?

By Charles Lewis Sizemore, CFA

In case you missed it…

September has been nasty. The stock selloff has created some fantastic opportunities I never expected to see again, and I'll get to that shortly. But first, I want to get some housecleaning out of the way. We've hit our stops in four positions. So, before we go any further…

Action to take: Sell your shares of Vertical Capital Income Fund (NYSE: VCIF) at market.

Action to take: Sell your shares of Healthcare Realty Trust (NYSE: HR) at market.

Action to take: Sell your shares of Physicians Realty Trust (NYSE: DOC) at market.

Action to take: Sell your shares of Main Street Capital (NYSE: MAIN) at market.

Furthermore, we have one other position that is close to our stop that we'll need to monitor, **National Storage Affiliates (NYSE: NSA).**

Each of the four stocks that were stopped out – along with the fifth that is close – have one common tie that binds. All are extremely sensitive to changes in long-term interest rates.

Figure 1

Real estate investment trusts (REITs) are sensitive in two distinct ways. In the low yield world we've lived in for most of the past two decades, REITs have come to be viewed as a substitute for bonds. Falling bond yields (and rising bond prices) meant falling REIT yields and falling REIT prices. And with market yields now soaring, both bonds and REITs are tanking.

But beyond that, REITs also tend to be highly leveraged. It comes with the turf of managing a real estate portfolio. Rising funding costs make new properties more expensive to finance and cuts into profitability. And then there is the possibility that the Fed's aggressiveness will push us into a bona fide recession, which would potentially ding property prices and depress rents.

Now, I should be clear that I don't see it getting anywhere NEAR that bad. REITs have had a handful of selloffs over the past decade, generally happening whenever the Fed is tightening. They tend to be short lived, and as a long-term holding, it's hard to lose money in a portfolio of quality REITs.

A Look a the Mortgage Market

But to show you what we're up against in the short term, take a look at the Figure 1 on the previous page. The average mortgage rate is close to 7%. They haven't been this high since the fourth quarter of 2008.

Mortgage rates have more than doubled over the past year. Playing with the numbers, a $400,000 mortgage gives you a payment of around $2,900 with mortgage rates at 6.8%. That same mortgage with rates at 3% would get you a payment in the ballpark of $2,000.

Now, obviously, property taxes and other factors can skew the numbers higher or lower. But the takeaway is clear. Faced with massively higher mortgage rates, a homebuyer today has two options. They either accept a higher payment and make cuts elsewhere in the budget. Or they buy a cheaper house.

Now, if you're an existing property owner with long-term financing, this isn't necessarily a disaster. Lack of affordability to buy should keep demand high for rentals.

But across the economy, this is bad news. Home prices will likely have to fall to bring affordability back in line, which will wipe out the equity of a lot of recent buyers and make it virtually impossible for them to sell.

A less liquid housing market means less spending on big ticket items like appliances and furniture. It also makes for a less mobile labor market, as would-be hires might be less willing to pack up and move to a new city for a job if it meant taking a bath on their house and potentially losing hundreds of thousands of dollars in home equity.

Something has to give here. While I know the Fed is serious about taming inflation, it's hard to see Chairman Powell being comfortable with engineering a major real estate crash. After all, we all know how the last one went. Remember "QE Infinity"? The Fed had to pump unprecedented liquidity into the market, which sowed the seeds of the "everything bubble." 2022 witnessed the bursting of the everything bubble.

Long story short, I don't see the Fed going so far as to lower the targeted Fed Funds rate any time soon. But I wouldn't be surprised to see them step in to support the mortgage market on the longer end of the yield curve.

We'll see. In the meantime. It's important to remember that, prior to 2008, rates at these levels were perfectly normal. So, I tend to have a high comfort level with companies that have a lot of experience navigating this kind of environment.

A New Forever Stock

So, with all of that as background, I'm going to add a new stock to our "Forever Portfolio" today.

You know I love my **Realty Income (NYSE: O)**. It's one of my all-time favorite stocks and a founding member of the Forever Portfolio.

Well, today I'm recommending its closest competitor, **National Retail Properties (NYSE: NNN)**.

Both of these REITs are "triple net" landlords, meaning the tenants are responsible for handling all maintenance, taxes and insurance expenses. (National Retail identifies so much with this business model, they close "NNN," which is shorthand for "triple net," as their ticker symbol.) In an arrangement like this, the landlord's only real job is to cash the rent check.

That's a little bit of an exaggeration, of course. But it is absolutely true that management spends very little time managing *properties*. Their time is spent managing the *portfolio*, looking for new properties and managing an optimal mix.

One nice thing about bear markets is that they have a way of resetting the clock. NNN got absolutely hammered during the COVID bear market, as some

Figure 2

Figure 3

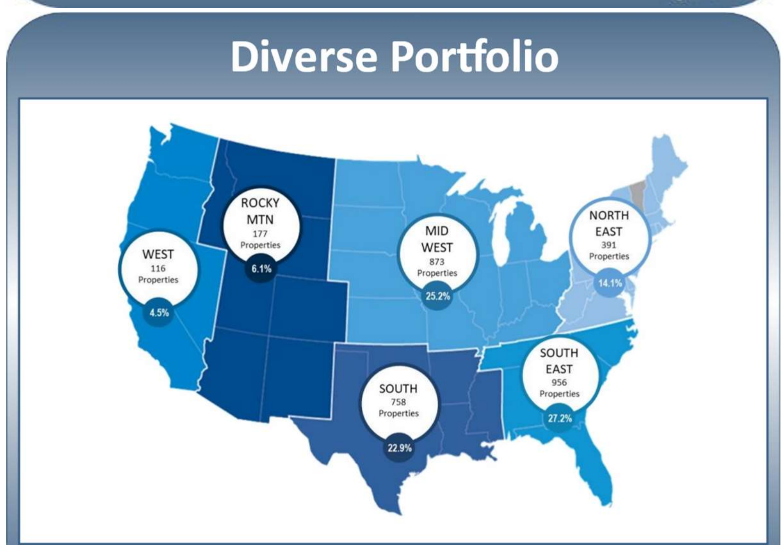

Figure 4

of its retail-focus tenants really struggled due to quarantine related closures. And before the shares could really recover, we got the great inflation and interest rate spike of 2022, which caused the shares to crash all over again.

Today, NNN's shares trade at 2013 levels (Figure 2 on previous page). If you're not going to buy a healthy company when it's trading at prices first seen nearly a decade ago… well, when would you?

NNN's management likes to boast that the REIT's portfolio is "future proof," which is to say Amazon proof. The pandemic really accelerated a lot of the trends that have been in place for two decades now, such shopping online and working from home.

A short glance at NNN's portfolio is enough to confirm this. You may need to zoom in a little to see the detail on Figure 3, but this breaks down NNN's portfolio by segment. The largest piece, at 17.5%, is convenience stores like 7-Eleven or Circle K. These are high-traffic stores that consumers tend to run in and out of while on the go. I suppose there is the long-term risk that Amazon will start delivering Slurpees by drone at some point in the future, but I don't think that's anything we need to realistically worry about any time soon.

NNN also has 12.6% of its portfolio in carwashes and other auto-related businesses and 9.7% and 9.2% in full-service restaurants and fast food joints, respectively. The rest of the portfolio is small and diversified with no industry making up more than 6% of the total.

Furthermore, NNN is well diversified geographically (Figure 4). It's biggest region, the Southeast, makes up only about 27% of the total.

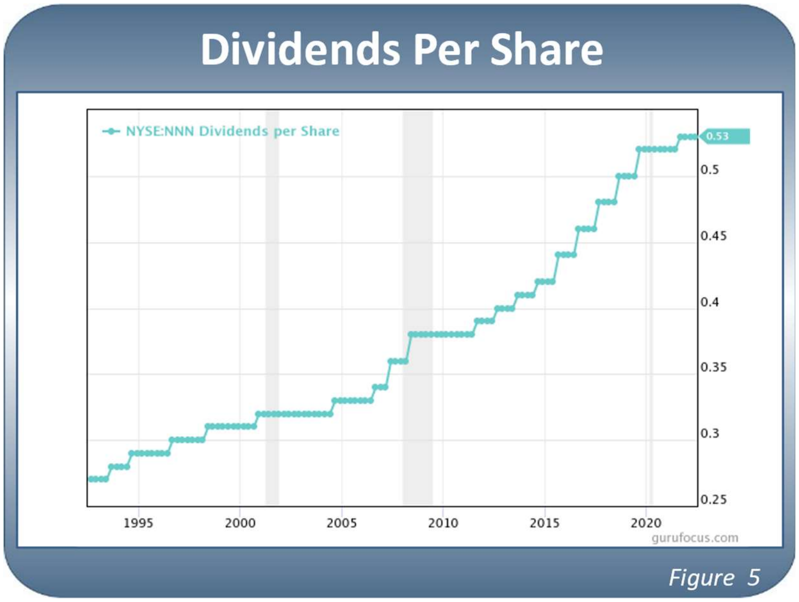

Figure 5

At current prices, NNN yields 5.6%. That's a fantastic payout for this stock, and it's only briefly touched these levels a few times over the past decade.

Furthermore, the REIT is a dividend-raising machine, having boosted its payout for 32 consecutive years (Figure 5).

Importantly, the dividend is well covered, making up only about 67% of adjusted funds from operations. So, if by some strange chance, NNN sees some of its tenants struggle or hits some sort of rough patch, it should have absolutely no problem supporting its dividend for the foreseeable future.

Now, let me be clear. You're not going to get rich in National Retail Properties, or at least not quickly. But that's not what we want in "forever" stocks. We want steady consistency. And that's exactly what NNN offers.

I would have added this one to the list earlier had it been a little cheaper. But

Stock	Ticker	Entry Date	Buy Price	Recent Price	Stop Loss	Yield	Cumulative Dividends	Total Return	IRA Friendly?
National Retail Properties	NNN	9/29/2022	$ 39.09	$ 39.09	None	5.63%	$ -	0.00%	Yes
Conagra Brands	CAG	6/23/2022	$ 32.47	$ 33.26	None	3.97%	$ 0.33	3.45%	Yes
The Clorox Company	CLX	6/23/2022	$ 132.28	$ 133.15	None	3.54%	$ 1.18	1.55%	Yes
Campbell Soup Company	CPB	6/23/2022	$ 47.04	$ 46.99	None	3.15%	$ 0.37	0.69%	Yes
Flowers Foods	FLO	6/23/2022	$ 24.97	$ 25.12	None	3.50%	$ 0.22	1.48%	Yes
General Mills	GIS	6/23/2022	$ 67.90	$ 77.82	None	2.78%	$ 0.54	15.41%	Yes
J.M. Smucker Company	SJM	6/23/2022	$ 123.83	$ 139.04	None	2.93%	$ 1.02	13.11%	Yes
Target Corporation	TGT	6/23/2022	$ 141.08	$ 151.76	None	2.85%	$ 1.06	8.32%	Yes
Coca-Cola Company	KO	4/27/2022	$ 65.56	$ 56.58	None	3.11%	$ 0.88	-12.36%	Yes
Prologis	PLD	10/29/2021	$ 146.67	$ 101.20	None	3.12%	$ 3.00	-28.96%	Yes
Crown Castle International	CCI	10/29/2021	$ 181.90	$ 144.27	None	4.08%	$ 5.88	-17.46%	Yes
Philip Morris International	PM	3/30/2021	$ 89.35	$ 86.25	None	5.89%	$ 6.22	3.50%	Yes
Altria Group	MO	3/19/2020	$ 37.10	$ 41.19	None	9.13%	$ 9.66	37.05%	Yes
Realty Income	O	3/19/2020	$ 48.08	$ 57.97	None	5.10%	$ 7.16	35.45%	Yes
AT&T	T	3/19/2020	$ 31.15	$ 15.52	None	7.15%	$ 5.24	-33.38%	Yes
Enterprise Products Partners	EPD	3/19/2020	$ 14.52	$ 23.85	None	7.97%	$ 4.54	95.52%	No
Kinder Morgan	KMI	3/19/2020	$ 11.20	$ 16.71	None	6.64%	$ 2.69	73.20%	Yes
Ventas	VTR	3/19/2020	$ 19.98	$ 39.65	None	4.54%	$ 4.84	122.66%	Yes
Public Storage	PSA	3/19/2020	$ 187.60	$ 287.56	None	2.78%	$ 33.15	70.95%	Yes
International Paper	IP	3/19/2020	$ 30.13	$ 32.11	None	5.76%	$ 4.77	22.39%	Yes
STAG Industrial	STAG	3/19/2020	$ 21.71	$ 28.20	None	5.18%	$ 3.62	46.58%	Yes
Retail Opportunity Investments	ROIC	3/19/2020	$ 7.25	$ 13.53	None	4.43%	$ 1.12	102.07%	Yes

following the recent bloodbath in the REIT sector, it's now simply too cheap to ignore.

So, without any further ado…

Action to take: Buy shares of National Retail Properties (NYSE: NNN). Plan to hold forever, collecting the growing stream of dividends.

I mentioned earlier that REITs were getting slammed by rising interest rates. That's ok. Yields won't rise forever, and NNN has proven its ability to navigate virtually every kind of interest rate scenario under the sun. I consider this a fantastic entry point.

Another Trade: T-Bills!

I can't believe I'm saying this, but I'm also going to recommend you pick up some short-term T-bills this month.

After three monster 0.75% rate hikes, short-term yields are properly high again. Two-year Treasuries can be bought yielding around 4.2% today.

Thus far, I have yet to other safe instruments, such as bank CDs, approach these yields. They may still if the Fed keeps jacking up rates. But for the moment, the short-term T-bills are the best deal in town. And unlike CDs, T-bills are liquid. If you own them in a regular brokerage account or IRA, you can sell them without penalty at any time.

Given the low duration of a two-year bond, your interest rate risk is extremely modest. Rising interest rates won't slam short-term T-bill prices the way they slam longer-duration bonds.

The yield curve is inverted right now, meaning that short-term yields are higher than long-term yields (Figure 6).

The high point in the curve is the 2-3 year mark. In this range, you're getting a nice yield of about 4.2%, no credit risk, and only infinitesimally small interest rate risk.

Let's briefly talk about interest rate risk. As you know, rising yields mean lower bond prices. But this sensitivity is smaller for shorter dated bonds.

Let's say you buy a zero-coupon two-year Treasury. The modified duration on the day you buy it is just shy of two. That means that for every 1% rise in market yields, the price would decline 2%. But remember, that's your risk on day zero. Every day you hold the bond, the duration gets a little shorter. By the time you've held it six months, your duration is down to 1.4, meaning a 1% spike in interest rates would only cause the bond price to decline by 1.4%. A year in, you're down to less than 1. And so on.

And of course, if you hold the bond to maturity, there is no interest rate risk.

Could the 2-year yield rise another couple percent from here? Yes, of course it could. Anything could happen in this environment. But I don't expect yields on that section of the yield curve to go much higher, and 4.2% isn't a bad deal. It's the highest we've seen in well over a decade.

I had a client ask me the other day why anyone would buy a 10-year or 30-year Treasury when the yields were lower than on the more conservative 2-year.

Well, that's a good question and worth answering here!

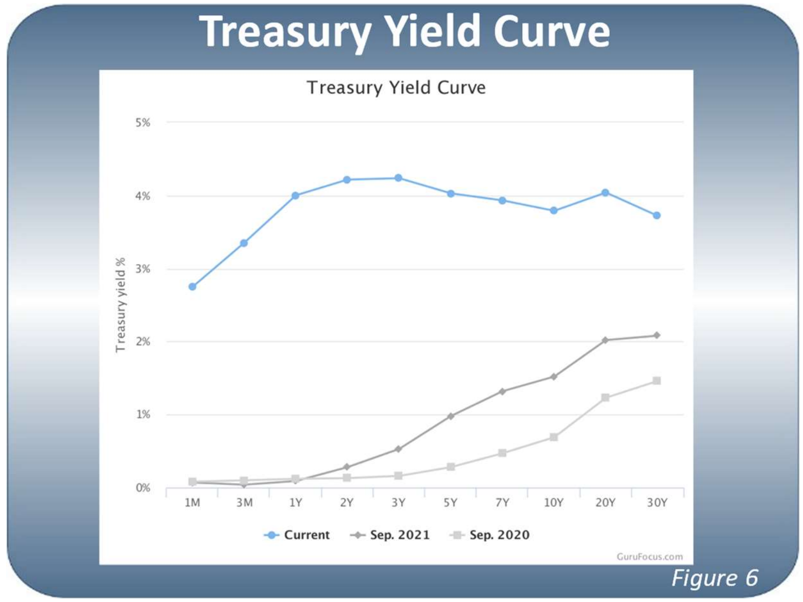

Figure 6

There are a couple reasons. To start, there is reinvestment risk. 4.2% is a great yield today, but what will yields look like two years from now? They might be a lot lower, so you would risk having to accept a lower yield in two years' time.

The other reason to buy longer-dated bonds is speculation. The duration on a 10-year zero coupon bond is close to 10, and on a 30-year zero coupon bond it is about 29.

That means that if long term yields were to fall 1%, which could easily happen in a recession, you'd make a good 10% on your 10-year bonds and a good 29% on your 30-year bonds.

Personally, I think it's likely that market yields are significantly lower a few years from now, meaning that it could be wildly profitable to buy long bonds at current yields, even if those yields are lower than 2-year Treasuries.

If you're having the itch to trade, go for it! There is risk, of course, but if you get the timing right you can make a bundle.

But my objective in buying 2-year Treasuries is different. I'm not looking to make 29% on this. I'm just looking for a safe place to park some cash until the market calms down. And a safe 4.2% guaranteed by the government isn't too bad…

Before I sign off, I want to throw something out there. If you've taken major losses in your portfolio this year and are looking for some alternatives, please contact my office at info@sizemorecapital.com. I may have some alternatives that are right up your alley.

That's going to wrap it up for now.

Have a good week, 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
National Storage Affiliates	NSA	8/30/2022	$52.95	$40.28	$39.16	5.46%	$ -	-23.93%	Yes	Buy
Cheniere Energy Partners	CQP	8/4/2022	$46.49	$52.37	$33.01	6.66%	$ -	12.65%	No	Buy
Citigroup Inc	C	6/23/2022	$47.34	$42.42	$32.57	4.81%	$ 0.51	-9.33%	Yes	Buy
ONEOK, Inc.	OKE	4/28/222	$65.50	$51.99	$47.91	7.19%	$ 1.87	-17.77%	Yes	Buy
Vertical Capital Income Fund	**VCIF**	**1/27/2022**	**$9.99**	**$8.91**	**$8.95**	**9.55%**	**$ 0.58**	**-5.02%**	**Yes**	**Sell**
Energy Transfer Partners	ET	12/27/2021	$8.16	$10.98	$7.79	8.38%	$ 0.61	41.91%	No	Buy
EPR Properties	EPR	11/29/2021	$47.78	$35.20	$33.92	9.38%	$ 2.65	-20.78%	Yes	Buy
Chevron Corporation	CVX	9/30/2021	$103.33	$144.80	$130.77	3.92%	$ 5.60	45.55%	Yes	Buy
ClearBridge Energy Midstream Opportunity	EMO	5/26/2021	$21.94	$25.15	$20.49	8.11%	$ 2.16	24.48%	Yes	Buy
Magellan Midstream Partners	MMP	1/29/2021	$44.41	$47.79	$41.78	8.68%	$ 6.20	21.57%	No	Buy
Healthcare Realty Trust	**HR**	**7/20/2022**	**$24.37**	**$20.60**	**$22.12**	**4.72%**	**$ -**	**-15.47%**	**Yes**	**Sell**
Physicians Realty Trust	**DOC**	**11/20/2020**	**$17.80**	**$14.85**	**$15.30**	**4.49%**	**$ 1.61**	**-7.56%**	**Yes**	**Sell**
Main Street Capital	**MAIN**	**9/25/2020**	**$29.74**	**$33.19**	**$35.50**	**5.93%**	**$ 5.38**	**29.67%**	**Yes**	**Sell**
Iron Mountain	IRM	8/25/2020	$30.22	$43.82	$42.57	5.64%	$ 5.57	63.44%	Yes	Hold
Starwood Property Trust	STWD	8/25/2020	$15.70	$18.46	$18.15	10.40%	$ 3.84	42.04%	Yes	Buy
Ecofin Sustainable and Social Impact Term Fund	TEAF	6/24/2020	$10.73	$12.75	$12.53	8.47%	$ 2.15	38.82%	Yes	Buy