The Sizemore Income Letter

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Revisiting an Old Friend

By Charles Lewis Sizemore, CFA

It's been a while… but one of my favorite asset classes are on sale again. If you've been reading me since the *Peak Income* days, you know I'm a fan of closed end funds (CEFs)… but only under certain conditions.

Well… those conditions are now in place! The gyrations in interest rates last year effectively reset the clock.

We'll get to that… and to my pick for the month… in a minute. But first, let's talk macro. I want to revisit something I started last month.

The explosion in home prices in 2020 and 2021 was first and foremost a *bond* bubble. As part of its pandemic response, the Fed vacuumed up $120 billion per month in bonds and kept up that pace for nearly two years. About half of that total was in mortgage bonds. And the massive buying of mortgage bonds helped to push mortgage rates to levels so low no one believed them to be possible.

When the Fed stopped buying, mortgage jumped higher like a coiled spring. In less than a year, they soared from under 3% to over 7%.

Average 30-Year Mortgage Rate

Figure 1

As I wrote last month, mortgage rates are starting to trend lower again, and that trend has continued into this month.

And here is why that matters.

A semi-functioning housing market is critical to us avoiding a major recession. The longer rates remain elevated, the fewer homes get built and sold, the less furniture gets sold, the fewer construction workers get hired, the fewer trucks get leased, the more pressure remains on high rents, etc. I could go on all day, but you get the point. When housing dries up, it takes large swaths of the economy with it.

And everything becomes more manageable with lower mortgage rates.

Let me be clear: I do not see a return to the bubbly housing market of 2020-2021, and I wouldn't want to see a return to that even if it were possible. It's not normal for homes to sell for over asking price, and that market was never sustainable.

But if we are to have anything resembling a soft landing – and again, this is a big if – we need the housing market to unfreeze. And that's only possible if mortgage rates continue to trend lower.

So for now, let's call it cautious optimism that maybe – just maybe – we muddle through without a deep recession.

I'm not saying the bear market is over. That remains to be seen, and I suspect there is still a little more pain before we get a definitive bottom. But in the absence of a major recession, the bear market should at least be a little less deep.

My Favorite 90 Cent Dollars

And now, the moment you've been waiting for…

This month I'll be recommending a closed-end fund (CEF). It's been a while since I've recommended one, as 2022 was an awful year for CEFs. We actually got stopped out of most of the CEF positions we were in, and I was reluctant to add more because the pricing was lousy and I would have been trying to catch that proverbial falling knife.

So, if you're not familiar with them, I'll give you a short primer. (If you already have experience with CEFs, feel free to skip this section.)

A closed-end fund is a special type of mutual fund that shares certain things in common with their cousins: traditional open-end mutual funds and exchange-traded funds (ETFs).

But there are also critical differences that make CEFs very different from both, and CEFs are probably best understood by comparing them to the competition.

When you invest in a good old fashioned mutual fund, you (or your broker) actually sends cash to the fund, which the manager then uses to buy stocks, bonds or other securities. And when you redeem, the mutual fund manager will send you or your broker the cash, even selling securities to free it up if need be.

Exchange-traded funds are different. Investors can buy or sell ETFs exactly as they would any stock. They trade on major stock exchanges.

Unlike mutual funds, you don't actually send the manager money. New ETF shares can be created or destroyed by institutional investors based on market demand. (When shares are created, an institutional investor will essentially buy up the shares of stocks and bonds owned by the ETF, then trade them to the fund for shares of the ETF itself. When shares are destroyed, the institutional investor receives the underlying holdings.)

This creation and destruction of new ETF shares ensures that the ETF's market price never deviates too far from the net asset value (NAV), or the value of the underlying holds.

And this brings us to CEFs.

Like open-end mutual funds and exchange-traded funds, closed-end funds are pooled investment vehicles. You have many investors pooling their assets into a common fund, which is invested by a manager or a team of managers.

Unlike mutual funds – but *like* exchange-traded funds – closed-end funds trade on a stock exchange. You buy the shares in a brokerage account and never send the manager cash.

But unlike exchange-traded funds, closed-end funds have no creation or destruction of shares. A CEF has an initial public offering (IPO) when it creates its shares, and that number of shares is fixed. That might sound like a mundane detail, but it's actually one of the most important aspects of CEFs.

And here's why.

Net asset value is the value of a fund's net asset position (the value of the stocks, bonds, and other securities it owns minus any liabilities) dividend by the number of shares outstanding.

Open-end mutual funds are always valued at their net asset value. And with exchange-traded funds, the shares' net asset value will never deviate too much from the market price due to the creation and destruction mechanism. But because CEFs have no such mechanism, the market price of the shares can vary wildly from the net asset value. They can trade at large premiums to net assets or – as I like to look for – at deep discounts. You really can buy a dollar's worth of assets for 90 cents or even less when the pricing is right.

This discount to net asset value is a major contributing factor to the high yields we often see in this space.

Another factor is leverage.

Closed-end funds will generally borrow at least a modest amount, though it is not uncommon for a CEF to be leveraged as much as 30% to 40%. Of course, CEFs generally don't "borrow on margin" like regular mom-and-pop investors. They generally have access to more sophisticated—and cheaper—funding options.

Leverage is one of the factor that really hurt CEFs last year. It amplified the losses in what was a rough year across the board. But as investors dumped CEFs and ran for the hills last year, it's created a fantastic entry point for us today. And that same leverage stands to amplify our returns on the way back up.

Buying Real Estate on the Cheap

2022 was a tough year for real estate investment trusts (REITs). Because REITs have always had a major emphasis on income, investors came to view them as a bond substitute over the past two decades. But when bond yields surged last year – and bond prices collapsed – REIT prices also fell in sympathy.

But now that prices in the sector have reset, investors have a chance to buy quality real estate assets on the cheap. And there's an inflation angle as well. Land and building prices tend to at least keep pace with inflation over time, and commercial rental contracts will generally have rent escalators that will rise.

REITs are a fine way to get exposure to real estate. But why pay retail for them if you don't have to?

So, with no further ado, my recommendation this month is the **Nuveen Real Estate Income Fund (JRS)**, a CEF that invests in REITs.

You might remember this one. I recommended it in the June 2021 issue. We sold it in May of last year at a modest 4% loss when it hit our stop, and it continued to drop like a rock. We sold at $9.71, and it didn't hit bottom until $7.02.

The shares have been trending higher since October, and I believe the move is just getting started.

Let's take a deeper look.

It owns essentially the same collection of REITs you'd expect to find in any mutual fund or exchange-traded fund (ETF), such as logistics REIT Prologis (PLD) and senior living REIT Ventas (VTR) – both of which are in our Forever Portfolio – but it has the added benefit of owning them at a discount.

At current prices, JRS trades at a 7.36% discount to NAV, which is wide given this CEF's history. On only rare occasions has the CEF trading at a

Nuveen Real Estate Income Fund (JRS)

Figure 2

JRS Top 10 Holdings

NAME	% PORTFOLIO
Prologis Inc	8.4%
Highwoods Properties Inc	4.2%
Simon Property Group Inc	4.0%
Alexandria Real Estate Equities Inc	3.7%
Equinix Inc	3.6%
American Homes 4 Rent	3.4%
Cubesmart	3.3%
Equity Residential	3.0%
Kite Realty Group Trust	2.9%
Ventas Inc	2.9%

Figure 3

JRS Discount to NAV

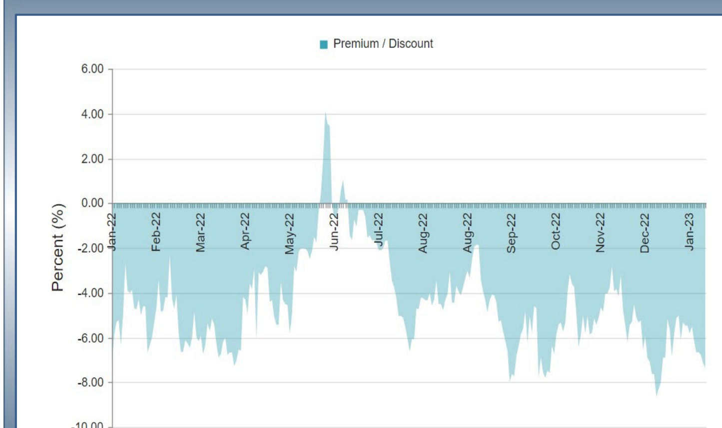

Figure 4

discount lower than about 8%. And for much of the 2010s, the CEF actually traded at a pretty significant premium to NAV of 5% to 10%.

JRS also yields a very juicy 9.77%.

So, what kind of returns can we expect here?

To review, CEF returns can come from three distinct sources:

1. The cash distribution
2. Improvement in the net asset value due to performance of the portfolio
3. A shrinking of the discount to net asset value

The yield is the easiest to understand. Assuming no distribution cuts, we should enjoy returns of 9.77% as the fund throws off cash.

Investment returns should also go in our favor. The Vanguard Real Estate Index Fund (VNQ) is a common REIT index fund we can use as a proxy for the sector. Well, at current prices, VNQ is sitting at 2016 prices. The sector has been treading water for years, and this was before the bear market of 2022, which sent the sector down about 23% from its 2021 highs. Even recouping half that loss would mean NAV returns of around 15%.

And the discount to NAV? Let's say we chop that in half as well. You're talking another 4%.

So, between the three sources of return, we're looking at potential returns of 30% in the next year or so based on very conservative assumptions.

It's hard for me to imagine getting a better return than that without taking substantially more risk.

So, with no more delay, please take the following action:

Action to take: Buy shares of the Nuveen Real Estate Income Fund (JRS) at market. Set an initial stop loss at $6.41 based on closing prices.

It's still early in 2023, and a lot can happen. The Fed might be successful in bringing inflation to heel. Or we might see several more quarters of high inflation. Only time will tell. But either way, it makes sense to own a little real estate, and JRS is a smart way to do so.

That's going to wrap it up for now. So long as pricing remains favorable, you can bet that we'll be revisiting the CEF sector in the months ahead. When the price is right… as they are today… this is one of the very best places to look for yield.

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
Nuveen Real Estate Income Fund	JRS	1/30/2023	$8.46	$8.46	$6.41	9.77%	$ -	0.00%	Yes	Buy
iShares MSCI Brazil ETF	EWZ	12/26/2022	$28.79	$29.65	$20.15	11.84%	$ -	2.99%	Yes	Buy
Atlantica Sustainable Infrastructure	AY	11/22/2022	$27.75	$26.83	$20.41	6.56%	$ -	-3.32%	Yes	Buy
AGNC Investment Corporation	AGNC	11/3/2022	$8.16	$11.28	$6.37	12.77%	$ -	38.24%	Yes	Hold
Cheniere Energy Partners	CQP	8/4/2022	$46.49	$53.82	$33.01	6.48%	$ 1.07	18.07%	No	Buy
Citigroup Inc	C	6/23/2022	$47.34	$51.75	$32.57	3.94%	$ 1.02	11.47%	Yes	Buy
ONEOK, Inc.	OKE	4/28/222	$65.50	$67.28	$47.91	5.56%	$ 2.81	7.00%	Yes	Buy
Energy Transfer Partners	ET	12/27/2021	$8.16	$13.10	$7.79	7.02%	$ 0.87	71.20%	No	Buy
EPR Properties	EPR	11/29/2021	$47.78	$41.78	$33.92	7.90%	$ 3.20	-5.86%	Yes	Buy
Chevron Corporation	CVX	9/30/2021	$103.33	$174.20	$130.77	3.26%	$ 7.02	75.38%	Yes	Buy
ClearBridge Energy Midstream Opportunity	EMO	5/26/2021	$21.94	$30.67	$20.49	6.65%	$ 2.68	52.01%	Yes	Buy
Magellan Midstream Partners	MMP	1/29/2021	$44.41	$53.49	$41.78	7.76%	$ 8.28	39.10%	No	Buy
Iron Mountain	IRM	8/25/2020	$30.22	$54.46	$42.57	4.54%	$ 6.19	100.69%	Yes	Sell
Starwood Property Trust	STWD	8/25/2020	$15.70	$20.48	$18.15	9.38%	$ 4.32	57.96%	Yes	Buy
Ecofin Sustainable and Social Impact Term Fund	TEAF	6/24/2020	$10.73	$13.19	$12.53	8.19%	$ 2.24	43.76%	Yes	Buy

The Forever Portfolio

Stock	Ticker	Entry Date	Buy Price	Recent Price	Stop Loss	Yield	Cumulative Dividends	Total Return	IRA Friendly?
National Retail Properties	NNN	9/29/2022	$ 39.07	$ 46.89	None	4.69%	$ -	20.02%	Yes
Conagra Brands	CAG	6/23/2022	$ 32.47	$ 36.97	None	3.57%	$ 0.33	14.88%	Yes
The Clorox Company	CLX	6/23/2022	$ 132.28	$ 142.15	None	3.32%	$ 1.18	8.35%	Yes
Campbell Soup Company	CPB	6/23/2022	$ 47.04	$ 51.90	None	2.85%	$ 0.37	11.13%	Yes
Flowers Foods	FLO	6/23/2022	$ 24.97	$ 27.01	None	3.26%	$ 0.22	9.07%	Yes
General Mills	GIS	6/23/2022	$ 67.90	$ 78.21	None	2.76%	$ 0.54	15.98%	Yes
J.M. Smucker Company	SJM	6/23/2022	$ 123.83	$ 151.60	None	2.69%	$ 1.02	23.25%	Yes
Target Corporation	TGT	6/23/2022	$ 141.08	$ 168.68	None	2.56%	$ 1.06	20.31%	Yes
Coca-Cola Company	KO	4/27/2022	$ 65.56	$ 60.64	None	2.90%	$ 0.88	-6.16%	Yes
Prologis	PLD	10/29/2021	$ 146.67	$ 127.79	None	2.47%	$ 3.00	-10.83%	Yes
Crown Castle International	CCI	10/29/2021	$ 181.90	$ 144.75	None	4.06%	$ 5.88	-17.19%	Yes
Philip Morris International	PM	3/30/2021	$ 89.35	$ 103.83	None	4.89%	$ 6.22	23.17%	Yes
Altria Group	MO	3/19/2020	$ 37.10	$ 44.50	None	8.45%	$ 9.66	45.98%	Yes
Realty Income	O	3/19/2020	$ 48.08	$ 67.77	None	5.10%	$ 7.16	55.84%	Yes
AT&T	T	3/19/2020	$ 31.15	$ 20.16	None	5.51%	$ 5.24	-18.47%	Yes
Enterprise Products Partners	EPD	3/19/2020	$ 14.52	$ 25.59	None	7.42%	$ 5.02	110.78%	No
Kinder Morgan	KMI	3/19/2020	$ 11.20	$ 18.04	None	6.15%	$ 2.69	85.07%	Yes
Ventas	VTR	3/19/2020	$ 19.98	$ 51.28	None	3.51%	$ 5.29	183.15%	Yes
Public Storage	PSA	3/19/2020	$ 187.60	$ 298.89	None	2.68%	$ 33.15	76.99%	Yes
International Paper	IP	3/19/2020	$ 30.13	$ 37.79	None	4.90%	$ 4.77	41.24%	Yes
STAG Industrial	STAG	3/19/2020	$ 21.71	$ 35.08	None	4.16%	$ 3.62	78.27%	Yes
Retail Opportunity Investments	ROIC	3/19/2020	$ 7.25	$ 15.37	None	3.90%	$ 1.12	127.45%	Yes