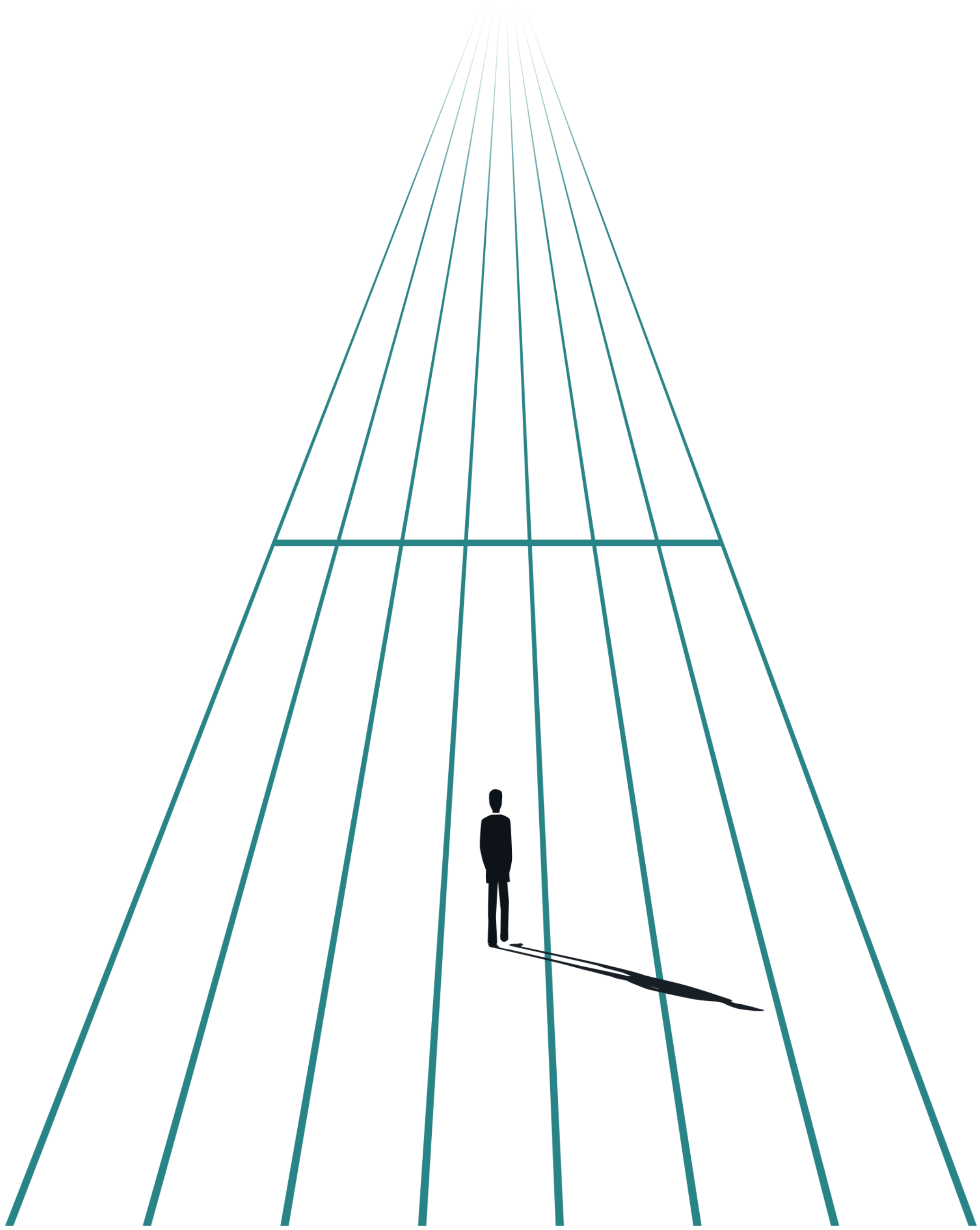
CALLODINE | CAPITAL

The Case for Value

A Road Map for Regime Change

November 2020



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Executive Summary

“The Greatest Growth Cycle in History”:

- Bull markets need three key ingredients in place to be considered “secular,” implying a semi-permanent success for one investment style over all others:
    1. **Strong fundamentals that initially support and reinforce investor conviction**
    2. **A simple narrative that appeals to investor logic and creates the need to own this particular investment trend for fear of missing out**
    3. **Price returns that generate and sustain price momentum and capital flows**
- The current secular bull market in Growth stocks, which we define as starting in 2007 and running through today, has exhibited all of these conditions for the better part of last 13-years.

Historical Context:

- The current market environment is reminiscent of the late 1990s cycle, when Growth strategies and technology stocks dominated the market, resulting in a repeat of the extreme disparity of relative valuations and performance witnessed then.
- The argument that a great rotation into Value could be imminent has been around for much of this cycle, but in failing to materialize, the risk of such a rotation has been all but eliminated from the mindset and corresponding valuation framework for most investors.
- ***We disagree*** and believe the likelihood of such a rotation has increased dramatically exiting 2020, and that the magnitude of such a reversal could potentially trigger the largest relative Value/Growth move in modern market history.

Risk vs. Reward:

- We believe that capital markets are currently pricing risk inconsistently across different security types and sectors, resulting in an illogical and unsustainable disparity of relative values and thereby creating the potential for outsized returns moving forward.
- Federal Reserve-induced low rates are the justification for the re-pricing of risk and low absolute yield across the fixed income landscape, as well as the exorbitantly high multiples witnessed in Growth equities, and yet these low rates have provided seemingly no benefit to high cash yielding Value stocks.
- This paradoxical treatment of Value-oriented equities highlights how deeply out of favor they have become and can resolve itself in one of two ways: either valuations of Value stocks with strong free cash-flow yields begin to benefit from the same low rates as the rest of the market, or the Fed-induced rally reverses itself, with those segments of the market that have gained the most from zero-bound rates having the farthest to fall.

Implications of a New Secular Bull Run:

- Looking at 200 years of equity market data, the current -64% drawdown in the Value factor is the worst on record, and in each of the prior 20 instances of drawdowns of -20% or more, Value has recovered in full what was lost through sustained outperformance.
- So, with history as a guide, we believe investors are being presented with a generational opportunity for relative outperformance in Value stocks.

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“The Greatest Growth Cycle in History”:

Ingredients for a “Secular Bull Market”

In order for a given investment style to enjoy sustained success over nearly all competing strategies, we believe three critical supporting conditions need to be present. These conditions include:

1. **Strong Fundamentals** – Powerful underlying performance, at either the industry or company level, is essential for a secular bull run, especially at the beginning. The allure of an ultimate payoff always underpins an investor’s decision to back an emerging trend. This can be true in a relative or absolute sense.

2. **A Good Story** – Investors need a logical narrative behind the trend that they can easily understand and believe. As psychologist Daniel Kahneman once said, “No one ever made a decision because of a number. They need a story.”

3. **Strong Relative Returns** – Stock price appreciation is the third necessary condition. With positive returns providing the “proof” that validates both strong fundamentals and the narrative, creating self-sustaining price momentum.

In the table below, we’ve defined what we view as the great secular bull runs of Growth and Value over the last four decades. In each instance, the ingredients for a secular bull market—robust fundamentals, a compelling story and strong stock performance—were present at the outset. When these trends persisted for two years or longer, they were cemented as secular and believed to be semi-permanent by investors.

As those who invested through these market phases are painfully aware, each secular run ended abruptly, and for myriad reasons, but the formula to launch a dominant style regime holds true across each of these market phases.

Exhibit 1
Value vs Growth Return Cycles

Russell 1000 Value - Russell 1000 Growth Total Return
Nov 1980 through Sep 2020 (Monthly)

Start	End	Return	Length	Theme
Nov-80	Aug-86	31%	69	Corporate Activism and Capital Markets Innovation
Aug-88	Dec-91	-60%	40	Proliferation of the PC
Dec-91	Dec-97	39%	72	Gulf War, NAFTA
Dec-97	Feb-00	-73%	25	Internet Adoption and Dot.com craze
Jun-00	May-07	119%	83	"Peak Oil", Repeal of Glass-Steagall
May-07	Dec-15	-53%	103	Online Consumption, Social Media
Dec-16	Sep-20	-101%	44	Artificial Intelligence, Mobility / Work from Home

Sources: Bloomberg, Callodine Capital Research Team. Length of Cycle in months. Callodine defines the current Growth cycle as having commenced in May 2007 for the purposes of this paper.

Methodology: Return column is calculated as difference in cumulative total return of Russell 1000 Value - cumulative total return of Russell 1000 Growth over time frame.

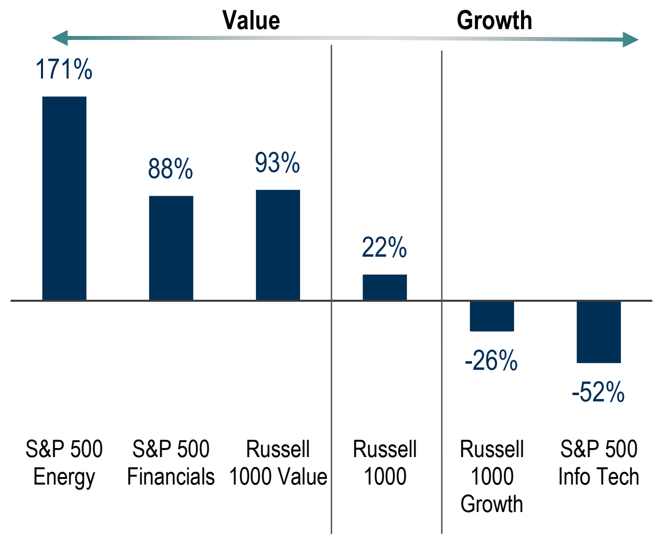
Birth of the Current Growth Boom

From June 30, 2000, through May 31, 2007, Value-oriented sectors were on a tremendous run, dramatically outperforming both the broader market and Growth stocks in particular (see Exhibit 2 at right). Relative valuations for Growth had collapsed back to pre-dot.com levels, and the power of deregulation within the financial sector (through the 1999 repeal of the Glass-Steagall Act) and the "peak oil" mantra in the energy sector had become key secular drivers that appeared unlikely to cease any time soon.

Hindsight has not proven kind to these views, nor to the market's lack of foresight with respect to the looming tsunami of online consumption, iPhone innovation (first released in 2007) and the coming influence of social media. What actually transpired was the complete collapse of the central drivers behind Value's outperformance and a period of significant relative earnings and price outperformance for Growth stocks (Exhibit 3 Panel A).

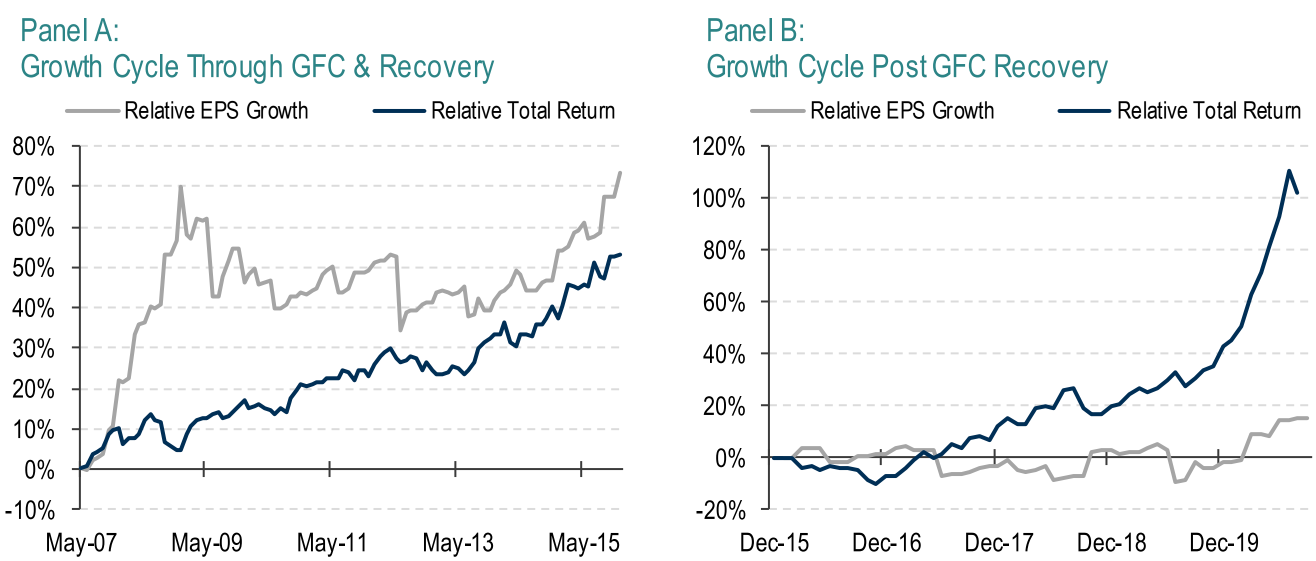
Coming out of the Global Financial Crisis (GFC), the macroeconomic framework of low growth and low rates, combined with the abrupt change in the prevailing narrative for the former winning sectors, set up Growth stocks to replace Value stocks as the next secular leader. Low interest rates and new capital requirements crippled the financial sector while enabling enormous amounts of cheap money to get funneled into the U.S.

Exhibit 2
Index Total Return Post Tech-Bubble



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Total Returns as calculated by Bloomberg from June 30, 2000 through May 31, 2007

Exhibit 3
Growth vs Value Relative EPS Growth & Total Return



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Relative EPS Growth = Percentage change in Russell 1000 Growth LTM EPS - Percentage Change in Russell 1000 Value LTM EPS. Relative Total Return = Percentage change in Russell 1000 Growth TR Index - Percentage change in Russell 1000 Value TR Index. Calculated on a month end basis from May 2007 through Dec 2015 and from Dec 2015 through Sep 2020.

energy sector. This inexpensive capital spurred overinvestment and undermined the bull case for commodities via increased supply and competition for land.

Interestingly, access to cheap capital has had the opposite effect on Growth investors analyzing the technology and health sciences sectors. In technology, inexpensive capital has fueled the current secular Growth story and created a positive feedback loop, as capital flows into technology end markets (thereby driving strong fundamentals) and the ever-rising valuations of technology shares have created dramatic price momentum in the sector. This feedback loop has resulted in the current “wash, rinse, repeat” cycle for 13 years running.

As Growth’s secular bull run has continued, however, we have seen relative multiple expansion take center stage from relative fundamentals as the key performance driver. Since late 2015, earnings-per-share (EPS) growth between the Growth and Value segments of the market has been relatively equal, even when factoring in the cyclical impact of the current pandemic, which has favored Growth stocks. What has not been equal is the performance of the underlying stocks, with Growth massively outperforming Value over the last five years, exacerbated by a dramatic run-up during 2020 (see Exhibit 3 Panel B on previous page). In fact, the strongest relative returns of the entire 13-year Growth cycle have come in the last 12 months, as COVID-related relative earnings strength has been compounded and amplified by explosive relative multiple expansion.

Historical Context for the Current Environment:

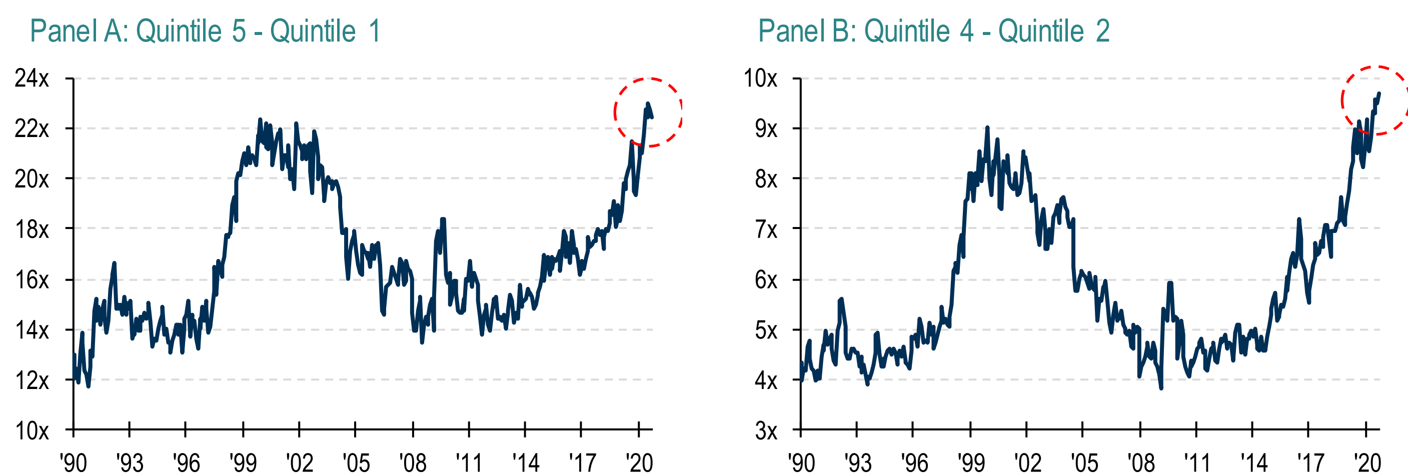
Have we Seen this Movie Before?

We believe the relative divergence in value between Growth and Value stocks is both irrational and unsustainable, and it is difficult to overlook the many similarities between today’s market environment and that of the late 1990s. The valuation differential between companies that the market has deemed “winners” and “losers” is staggeringly high on an absolute basis, with an even wider disparity in valuation spreads between the top and bottom quintiles in today’s market than the late 1990s. This spread has recently been expanding at a seemingly parabolic rate, setting up a potentially powerful reset if the historic pattern of an eventual correction and convergence back to “normal” spreads plays out.

Additional signs pointing to the extreme state of the current market cycle are abundant. Traditional growth sectors (such as healthcare and technology) often demonstrate an inverse relationship with traditional value sectors (such as energy and financials) as a percentage of global equities, with one group ceding share to the other alternately. Today, the market weighting of healthcare and technology (48%) represents a level we have not seen since the early 2000, with energy and financials representing an even lower share of total market weighting than those two sectors did at the peak of the tech

Exhibit 4

S&P 500 NTM P/E Valuation Spreads



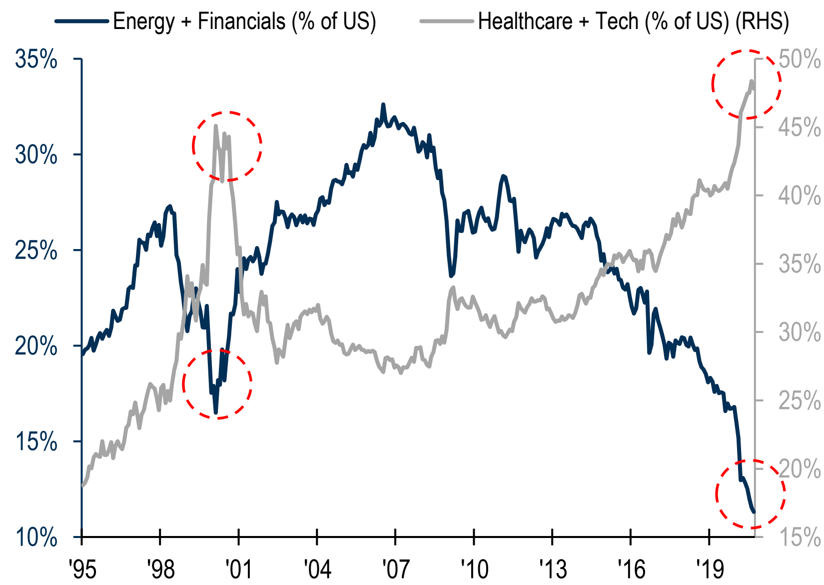
Sources: Bloomberg, Callodine Capital Research Team

Methodology: Average NTM P/E of S&P 500 companies quinitiled on NTM P/E multiple, excluding securities with forward consensus P/E ratios below 3x or exceeding 40x. Calculated on a month end basis from Jan 1990 through Sep 2020.

bubble (see the chart at right). But this pattern is not unique to secular bull markets in Growth. We saw the same phenomenon when Value stocks took a disproportionate share of the market leading into the GFC before that trend reversed course. Such sudden sector dominance, therefore, has been a leading indicator of an inflection point in style leadership.

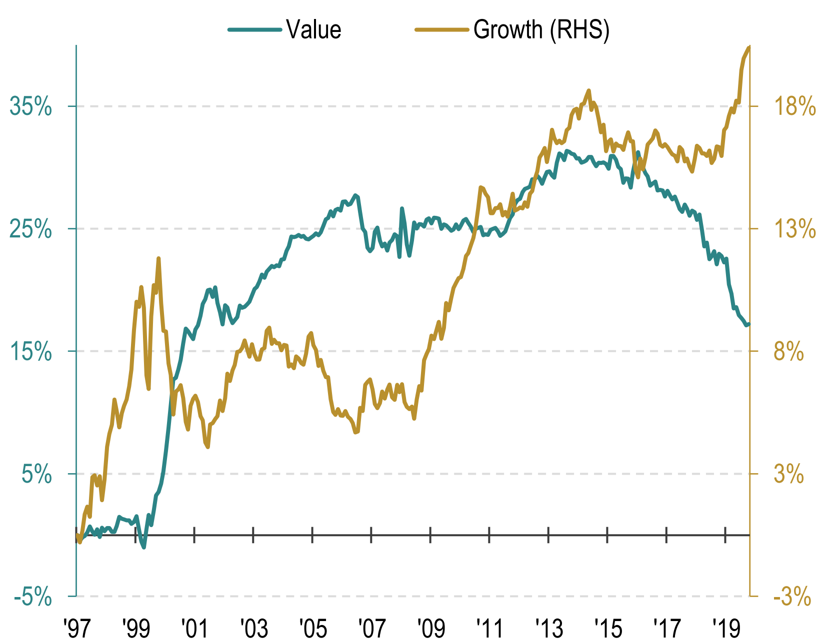
Looking at pure factor performance over the same timeframe, we can see that the Growth factor significantly outperformed Value heading into the late 1990s. But like the inflection points in sector dominance shown in the chart at right, Growth and Value factors witnessed sharp reversals in their performance during the ultimate correction. Today, performance has once again diverged, with Growth heading sharply higher, while Value has gone in the opposite direction. Time will tell if these trends repeat this pattern, but we believe such drastic outperformance of pure Growth and simultaneous underperformance of Value cannot be sustained in perpetuity and instead reflect a market primed for reversal, breaking the momentum cycle in the process.

Exhibit 5
Composition S&P 500 Index Free Float Market Cap



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Summation of free float markets caps for the S&P 500 Energy Index and S&P 500 Financials Index as well as the summation of the S&P 500 Health Care Index, S&P 500 Information Technology Index, and S&P 500 Interactive Media & Serives divided by the free float market cap of the S&P 500 Index. Calculated on a month end basis from Jan 1995 through Sep 2020.

Exhibit 6
Pure US Factor Returns



Sources: MSFS, Callodine Capital
Methodology: Geometrically linked monthly factor returns from Barra US Slow Risk Model. Value factor is composite of average monthly return of Value and Earnings Yield factors.

Late-Cycle Dynamics and Potential Reversal

So where are we in the story arc of Growth's current secular bull market? We would argue very late.

It would seem logical to conclude that the fundamental outperformance of Growth sectors cannot last indefinitely, yet the valuations and current capital flows would argue otherwise. The capital that has poured into the technology sector alone over the past decade has changed the competitive landscape for many industries. Start-ups backed by well-funded venture capital firms are entering a more crowded field today than FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) and many other Growth veterans did at their starts, as their formative growth took place in the post-bubble era of investor technophobia. In addition, FAANG stocks are now weaponizing their incredibly low cost of capital against one other and all start-ups in their paths as they increasingly compete in overlapping verticals.

In evaluating past market cycles, we have found that inflection points are often caused by the breakdown of one of our aforementioned bull market ingredients. Frequently, the underlying fundamentals begin to deteriorate toward the end of the cycle but are explained away initially. In the chart at right, we disaggregate the return contribution for Growth stocks leading into the market peak in the late 1990s and early 2000s before the bubble burst. Earnings contribution, while strong, began to decline in the late 1990s. However, this trend did not stop multiples from expanding, and Growth stocks continued to earn positive returns into the new millennium as rising valuations carried the day. Eventually, the fundamentals mattered and multiples collapsed, resulting in significant negative performance for stocks.

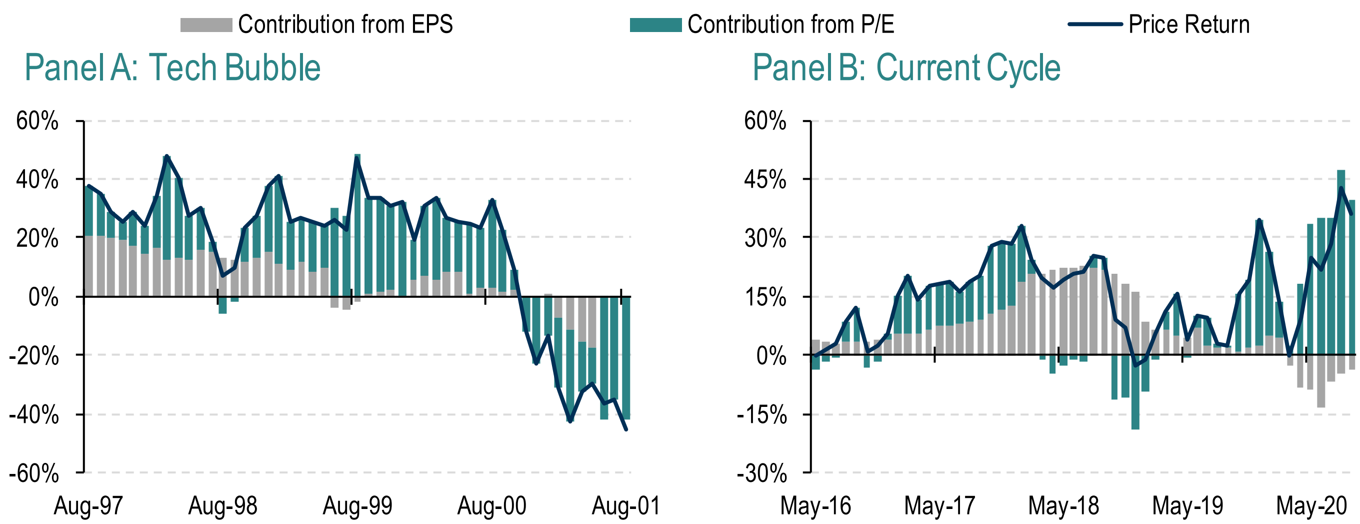
Today, we can see a similar and even more pronounced pattern repeating itself. EPS contribution to Growth's price performance has been strong over the past five years. However, EPS has slowed in the last two years and has actually acted as a drag on stock performance in 2020. This fundamental slowdown has been overwhelmed by an upward burst in price multiples, with surging valuations driving all of the positive stock performance for Growth (and then some) in 2020.

While earnings weakness can be explained away by the current pandemic-wracked economy, it nonetheless sets up the dynamic where Value stocks, having been even harder hit in 2020, are likely to experience very strong relative fundamentals moving forward. This attacks the heart of the narrative and sets up the potential for a dramatic relative rotation. Any break in price momentum, which serves as the justifying bedrock to the current Growth stock cycle, would then complete the breakdown of all three key conditions for the current secular bull run to continue.

The argument that a great rotation into Value could be imminent has been around for much of this cycle, but in failing to materialize, the risk of such a rotation has all but been eliminated from the mindset and corresponding valuation framework for most investors. ***We disagree*** and believe the likelihood of such a rotation has increased dramatically exiting 2020, and that the magnitude of such a reversal could potentially trigger the largest relative Value/Growth move in modern market history.

Exhibit 7

Contribution to Price Return of Russell 1000 Growth Index (Tech Bubble vs Current Cycle)



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Rolling 12 month calculation. Tech Bubble calculations made on month end basis from Aug 1997 through Jul 2001. Current Cycle calculations made on month end basis from May 2016 through Sep 2020. Price return = percentage change in price of Russell 1000 Growth Index. Contribution from EPS = percentage change in NTM EPS estimate of Russell 1000 Growth Index. Contribution from P/E = Price Return - Contribution from EPS.

Risk vs. Reward:

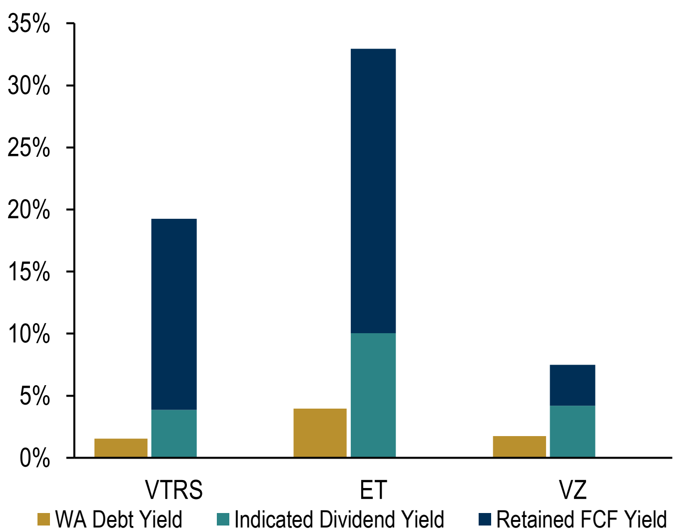
Reintroducing Risk into the Equation for Growth Stocks

We believe the application of a consistent risk framework across all markets is conspicuously absent in the current environment. Low interest rates and exorbitantly high multiples across Growth equities are being cited as justification for historically low yields in the fixed income market, and yet these low rates have provided seemingly no benefit to high–cash yielding Value stocks.

To illustrate this point, we look at several companies within the Value segment where the weighted average yield on the companies' debt is a fraction of the free cash flow (FCF) yield being afforded equity investors.

In the exhibit below, we examine the cost of capital for Viatris (VTRS; formerly known as Mylan), Energy Transfer (ET) and Verizon (VZ)—three companies from separate industries that are all rated investment grade and fall squarely within the Value bucket. [1]

Exhibit 8
Weighted Average Debt Yield vs.
Free Cash Flow Yield



Sources: Bloomberg, Callodine Capital Research Team

Looking at the risk-reward trade-off, we are confounded by the benign level of perceived risk being priced into these companies by the bond market (very little) and the FCF yield that the equity market is receiving as compensation for owning the stocks (very high).

It does not make intuitive sense to us for a company like Viatris to finance itself at a sub-2% weighted average debt yield while simultaneously generating a 20% FCF yield to the common equity.[2] Assuming reasonably efficient markets, there is no logical explanation for why such a large cost of capital arbitrage should exist. We have a difficult time reconciling what equity investors could possibly know about VTRS's prospects that would be damning enough to warrant such a low stock valuation, while bond holders are perfectly comfortable holding the underlying credit.

Follow the Flows

We contend that the prevalence of such diametrically opposed views in today's capital markets is the result of the uneven application across disparate markets of the massive liquidity infusion in 2020. Bonds trading at negative yields and technology stocks trading at infinite earnings multiples are two sides of the same Fed-supplied coin. Without the influx of liquidity provided by the Fed, it would be impossible to reconcile the bond market's adoption of a "lower for longer" philosophy on rates, suggesting a challenged period of growth with no risk of inflation moving forward, while Growth-oriented sectors of the equity market simultaneously price in an acceleration in real growth to justify extreme valuations. These outcomes are mutually exclusive in our view.

We believe each asset class is being priced accordingly, despite contradictory philosophies on forward growth, because of siloed capital flows. This year, fund flows have been strongest into fixed income and Growth stock markets; therefore, repricing has occurred in these areas. Sitting on the sideline during this global cross-asset rally is one of the largest sources of yield in the world, U.S. Value stocks. They are being resolutely ignored by

[1] We admit our bias here, as well as our conviction in our view, as we own VTRS, ET, and VZ in our portfolio. This should not be considered a recommendation to buy or sell any specific securities. There can be no assurance that such investments will remain in the strategy.

[2] Weighted average debt yield, indicated dividend yield and retained FCF yield per Bloomberg. For VTRS, we assume 25% of free cash flow will be paid out as a dividend, as stated on page 8 of the Company's August 2020 investment presentation titled "Path to Shareholder Value Creation."

income and equity investors alike, as if the cash generated by these securities doesn't spend the same way when it is received as a dividend rather than as a coupon payment.

This paradoxical treatment of Value-oriented equities can resolve itself in one of two ways: either yielding Value stocks with strong free cash-flow generation begin to benefit from the same low rates as the rest of the market, or the Fed-induced rally reverses itself and those segments that have gained the most from zero-bound rates have the farthest to fall. Either way, investors are faced with a disparity of relative values that is both illogical and unsustainable in our view, creating the potential for outsized returns moving forward.

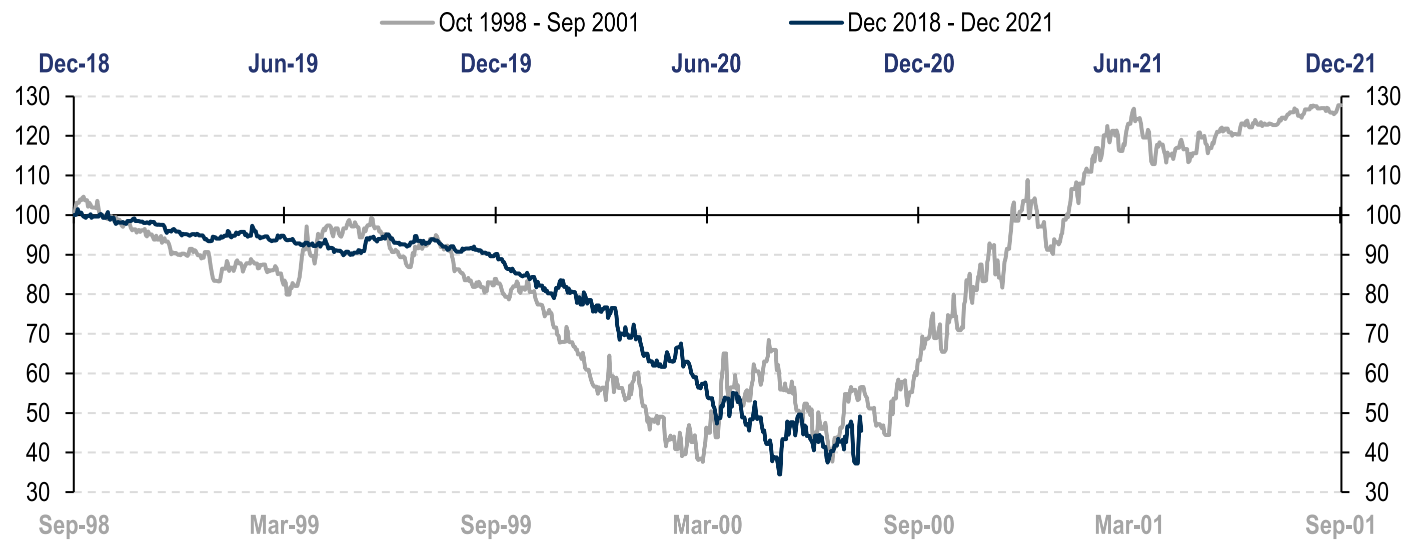
Prices Matter: The Road Not Taken

Call us old fashioned, but we believe future returns are dependent on the price you pay for an asset at the beginning, and that prices will indeed matter when the market changes its tenor.

If Growth and Value were the two divergent roads in Robert Frost's yellow wood, Value would certainly be the one less traveled. When sentiment shifts, however, a significant amount of capital will have to be reallocated to sectors and strategies that have been largely neglected. We saw this happen after the dot.com bubble burst, with previously underperforming Value strategies outperforming Growth for years to follow. This great rotation has been discussed in markets for years now, and seems obvious to most market participants, but the time that has lapsed since its occurrence has numbed investors to its potential power once unleashed (See Exhibit 9).

So, the question we assume is on most investors' minds is, what could spark this reversal in sentiment? While it is true that Growth has had its longest winning streak (>160 months) since the 1930s, we hesitate to say that Value will prevail simply because it hasn't taken the lead for a very long time. We do believe there are several factors that could trigger a reversal in this trading dynamic:

Exhibit 9
Value - Growth (Tech Bubble vs Now)



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Difference in geometrically linked daily total returns of the Russell 1000 Value Index less the geometrically linked daily total returns of the Russell 1000 Growth Index.

1. A breakdown could occur in one of the aforementioned "ingredients" that originally led to the dominance of the Growth trend:

- **The story no longer holds** – A global pandemic that accelerated technology adoption trends was the perfect accelerant for a parabolic rally in Growth stocks. In our Q2 2020 Investor Letter, "Schrödinger's Recession: Are We or Aren't We?," we discussed how the market did not respond as expected after posting a staggering 32.9% decline in U.S. gross domestic product (GDP). Unprecedented stimulus, coupled with an inability to spend in many categories, has generated a truly unique starting point in the U.S. economy. If a second wave of the virus causes continued economic struggles, Value could easily prolong its losing streak. However, markets look forward, not back, and the question will inevitably become, what's next? Value stocks have led the market out of 11 out of the last 14 recessions, and, given a provocative starting point, this catalyst may ultimately be what tests the secular bull market in Growth stocks.

- **Deterioration in fundamentals** – While certain bellwether Growth companies have performed remarkably well during the pandemic, the idea that all Growth companies have been resilient is false. In fact, if we were to look at the Outersection Russell 1000 Growth Index, we would see that more than 25% of the Index's constituents, based on the number of companies, have negative EPS for the last two years.[3] This percentage is higher than it was for Growth during the tech bubble and nearly twice as high as it was for Value in the aftermath of the GFC. These companies are wholly dependent on sustained, cheap external liquidity being provided to them. In bidding these companies ever higher, investors have fit a narrative to fundamentals which don't justify it.

- **Reversal in sentiment, price returns and subsequent fund flows** – When the momentum of Growth breaks, it could be a phenomenon that unwinds very quickly. Retail fund flows into technology stocks have gone parabolic in 2020, and we would be surprised if investors' capital proves to be "sticky" if returns suddenly become negative. Looking back at our table of past secular bull runs on page 3, the end was almost never pretty.

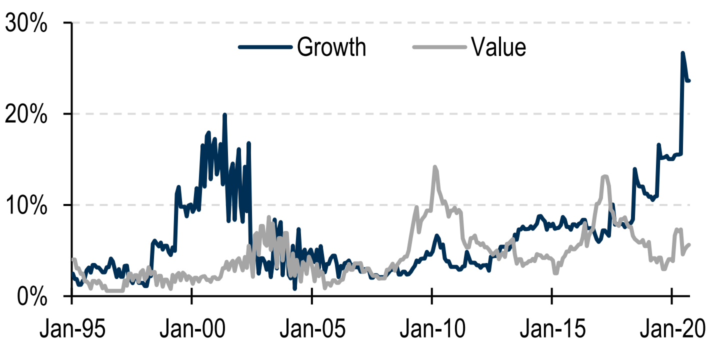
2. Macroeconomic factors could also engender change within style leadership:

At style inflection points, often the shock is exogenous and comes from the macro environment initially. For example, a global pandemic could exacerbate prevailing trends to unsustainable levels, thus triggering a generational reversal in course as things normalize post-crisis. What was viewed as secular, suddenly gives way to cyclical course correction.

- **Increase in rates** – The current low rate environment has been a boon for Growth stocks, with investors allocating their dollars to longer-duration assets with supposedly high terminal values. However, a reversal in rates, driven by

Exhibit 10

Percent of Companies with Negative EPS for Last 2 Years*

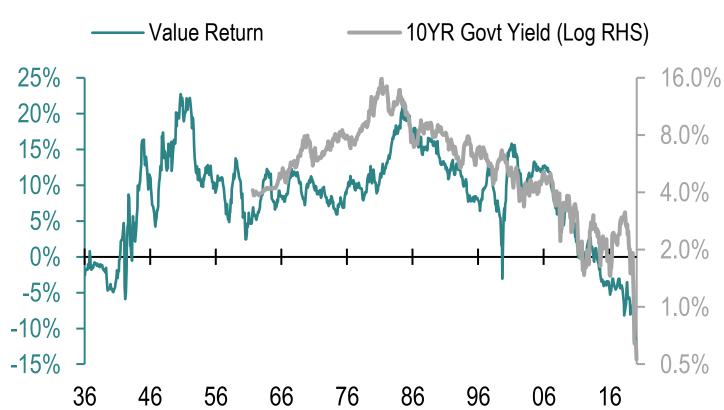


Sources: Bloomberg, Callodine Capital Research Team
Methodology: Number of companies in the outersection of the Russell 1000 Growth and Russell 1000 Value Indexes who have had negative EPS for the past 2 years, divided by the number of companies in the outersection. When a company only has one year of history, that one year is used. Calculated on a month end basis from Jan 1995 through Sep 2020.

Exhibit 11

Return to Value vs 10 Yield US Govt Yield

10 Year Rolling Annualized Return



Sources: Kenneth R. French, Bloomberg, Callodine Capital Research Team
Methodology: Value Return = rolling 10 year difference of return to high value stocks less low value stocks using Fama-French HML Methodology, annualized. Calculated on a month end basis from Jun 1936 through Jul 2020.

[3] The Outersection Russell 1000 Growth Index contains companies that are solely weighted to the Growth Index and are not split-weighted between Growth and Value Indices.

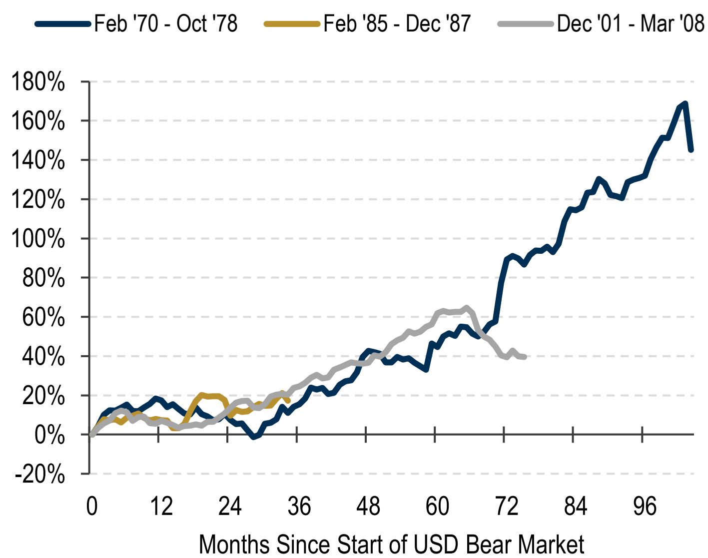
extreme fiscal policies, might cause investors to recognize the benefit of current income over an uncertain future. As shown in Exhibit 11, Value returns have traditionally had a fairly high correlation to rates, and, with such a low starting point, we believe the risk-reward trade-off skews toward Value.

- **Weakness in the dollar** – With the explosion in the U.S. Federal deficit resulting from the government's response to COVID-19, it is possible that the value of the U.S. dollar could suffer in the near- to medium-term. During past periods of dollar depreciation, Value has benefited. In Exhibit 12 we have tracked the performance of Value during three U.S. dollar bear markets dating back to 1970. In each instance, Value has been the beneficiary of a weaker USD.

- **A surge in commodity prices / inflation** – While perhaps not on the immediate horizon, a rise in inflationary pressure, stoked by a weaker dollar and/or an increase in energy prices, could be detrimental to the Growth trade. We have not seen sustained inflation above 5% since the early 1990s, so it would be understandable if market participants overlooked the second component of the Fed's dual mandate. But U.S. money supply skyrocketed in 2020, and we think investors would be remiss to forget what inflation can do for Value stocks, particularly in light of Fed Chairman Jerome Powell's recent dovish comments and apparent willingness to let inflation run above the long-term target in the pursuit of lower unemployment. As shown in the exhibit at right, Value returns have historically shown a positive correlation with inflation. Since the beginning of the current Growth bull run, that relationship has somewhat broken down, with Value declining more than expected given the overall change in price level. We believe an uptick in the pace of inflation might cause investors to recognize the benefits that shorter-duration, high-yielding Value stocks can provide in an inflationary environment.

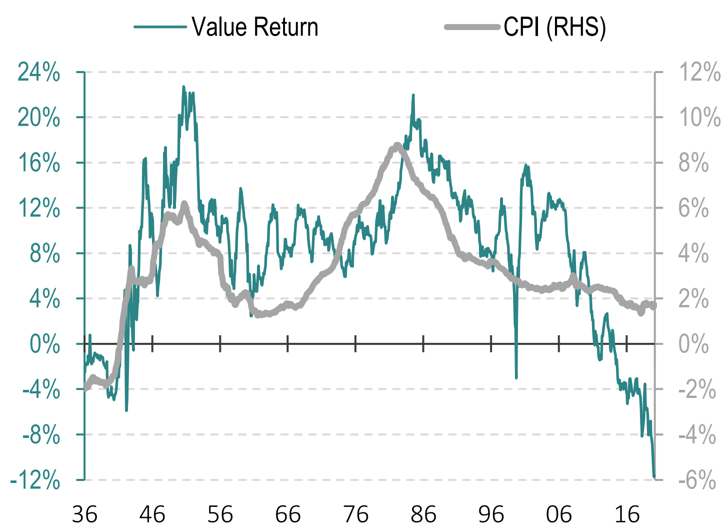
A final catalyst is the recent election of Democratic presidential candidate Joe Biden, which has captured investor attention since October and could have significant implications for the direction of the market and the U.S. economy in general. His election did not represent a "Blue Wave," as certain pundits had predicted—Republicans are expected to hold their advantage in the Senate, while Democrats lost seats in the House of Representatives. As it relates to market implications, a divided Congress may prevent President-elect Biden from moving forward with another major round of fiscal stimulus. With no stimulus check forthcoming to distort consumer behavior, the market may finally start to behave as it has historically when coming out of almost every other recession in recent memory,

Exhibit 12
Return to Value During USD Bear Markets



Sources: Kenneth R. French, Bloomberg, Callodine Capital Research Team
Methodology: Value Return = difference in cumulative return to high value stocks less cumulative return to low value stocks using Fama-French HML methodology. Calculated on a month end basis.

Exhibit 13
US CPI vs Return to Value
10 Year Rolling Return Annualized



Sources: Kenneth R. French, Bloomberg, Callodine Capital Research Team
Methodology: Value Return = rolling 10 year difference of return to high value stocks less low value stocks using Fama-French HML Methodology, annualized. Calculated on a month end basis from Jun 1936 through Jul 2020.

with Value leading the way.

News of a potential COVID-19 vaccine coming soon from Pfizer, Moderna and AstraZeneca also may have a positive impact on Value stocks. The prospect of a return to greater normalcy has already been helpful to certain segments within Value and delivered a small blow to previously impervious "stay-at-home" tech stocks that embody the disruption theme. While we cannot know the pace of distribution and adoption of a potential vaccine, a nascent recovery in economic activity could support various buckets of Value, including financials and commodity-related cyclicals.

High cash–yielding Value stocks could also benefit if the combination of a Democratic president and the proliferation of a viable vaccine results in a rise in interest rates. We have already seen Treasury yields begin to tick up in the U.S., with the 10-year note spiking to nearly 1.00% post-election. If this is the beginning of a steady creep higher in global yields, it could also be the beginning of a long recovery in Value. Investors who have flocked to Growth stocks with theoretically high terminal values may now begin to pivot toward shorter-duration Value stocks as the cost of capital increases alongside the present value of distributed cash flows.

We concede that there remains a reasonable theoretical case for Growth. However, we believe that the COVID-era, Fed-fueled rally has inflated values far beyond what any reasonable valuation framework could support. Moreover, the underlying trends in the market today are reminiscent of previous inflection points in style leadership that have repeated themselves throughout market history.

Implications of a New Secular Bull Run:

Perhaps Growth's secular bull run isn't over. Maybe the current 13-plus years of outperformance over Value will continue unabated, and the equity investment strategies that have enjoyed success in 2020 will continue to march onward, driving valuation disparities to unprecedented levels. But what if we're right? What if the time is approaching for Value to retake the throne?

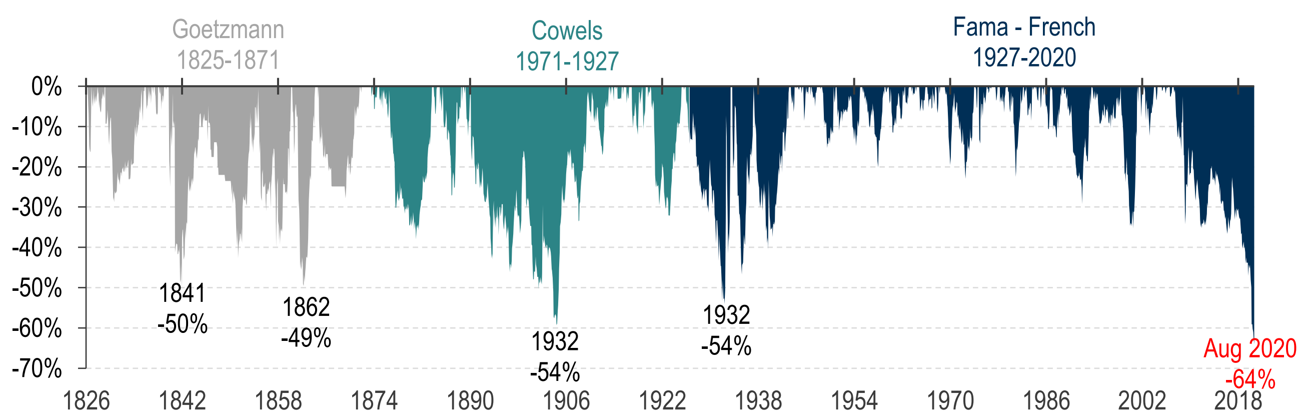
To answer this question, it is helpful to draw upon market precedent to put the current underperformance of Value into historical context. Courtesy of some creative research conducted by Two Centuries Investments, we see that the current drawdown in the Value factor, which reached -64% in August 2020, is the deepest in history, rivaled only by a slightly less painful -59% decline in 1904.[4] We also saw a similarly sized drop of -54% in 1932 during the depths of the Great Depression.

The periods that followed these vicious Value drawdowns were uniformly defined by sustained outperformance and tremendous returns to Value investors, with a full recapture of all that was lost—which has happened every time.

So, while Value investing can be a gut-wrenching exercise, perhaps never more so than during the past several months, the potential for long-term returns is quite compelling for investors who can weather the storm and stomach the volatility.

We believe the current market environment represents an outlier

Exhibit 14
194 Years of Value Factor Drawdowns (Dec 1826 - Aug 2020)
Two Centuries Investments Methodology



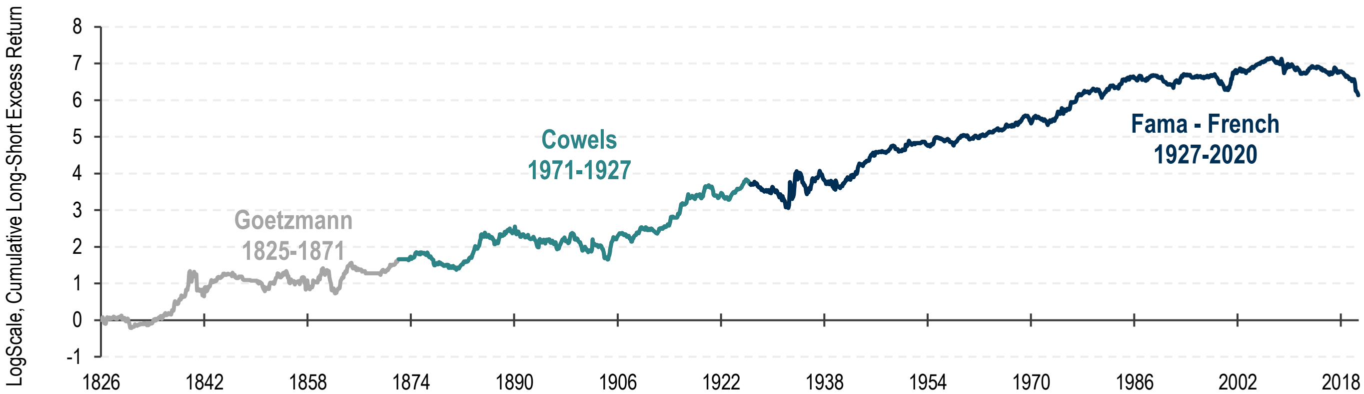
Sources: Two Centuries Investments

[4] Two Centuries Investments and Callodine are not affiliated.

Exhibit 15

194 Years of Value Factor Returns (Dec 1826 - Aug 2020)

Two Centuries Investments Methodology



Sources: Two Centuries Investments

of historic proportions, and the data in the preceding charts supports this thesis. For investors who have been long Value for the last decade, and especially for the last six months, we truly feel your pain. But we implore you not to give up the ship. For investors who have remained wary of Value, we encourage you to consider, if not embrace, the opportunity that you are presented with today. If history serves as a guide, this opportunity is potentially generational in magnitude.

Final Thoughts

Growth has had a tremendous run over the past decade, and we believe a significant portion of that outperformance has been justified by the fundamental drivers of Growth's underlying businesses. But as we evaluate current market psychology and the resulting stock valuations in the context of the broader economic environment, we firmly believe that we may soon see an end to Growth's style dominance.

While we acknowledge that timing this inflection point is an inexact science at best and a fool's errand at worst, we are confident that there has rarely been so clear an opportunity in modern market history to take a contrarian stance and embrace a value-oriented posture. With stock valuations completely diverging into the "haves" and the "have nots," the equity market is like a dry field—it may take only a small spark to catalyze change across the entire landscape. The current entry point valuations provide a low-risk, high-reward trade-off that is increasingly elusive in today's global market environment.

There is a perception held by certain market participants that Value investors are simply Luddites, refusing to embrace technological change and clinging to obsolete businesses and notions on how capital markets work in the current environment. To be sure, there are stocks within the Value segment of the market that fit this description and end game. However, there are also companies with stable, steady growth profiles that churn out tremendous amounts of cash flow and can be bought at historically attractive multiples, on both a relative and company-specific basis. That's why we believe it is paramount to invest with active managers within the Value space. We seek to make the critical distinction between which companies are being put out to pasture and which are simply unloved by the market because of the factor they represent—and we believe the latter cohort offers an incredible buying opportunity in a global market landscape flooded with liquidity and devoid of risk premium.

We acknowledge that Value investing does not appeal to everyone. For those investors who believe this time is different and that Growth's current secular bull run will continue indefinitely, we wish you good luck. At Callodine, we stand ready to capitalize upon the change in style leadership change that we believe is forthcoming.

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