CALLODINE | CAPITAL

Quarterly Market Commentary
Q1 2021

"Bohemian Rhapsody"

Market Commentary

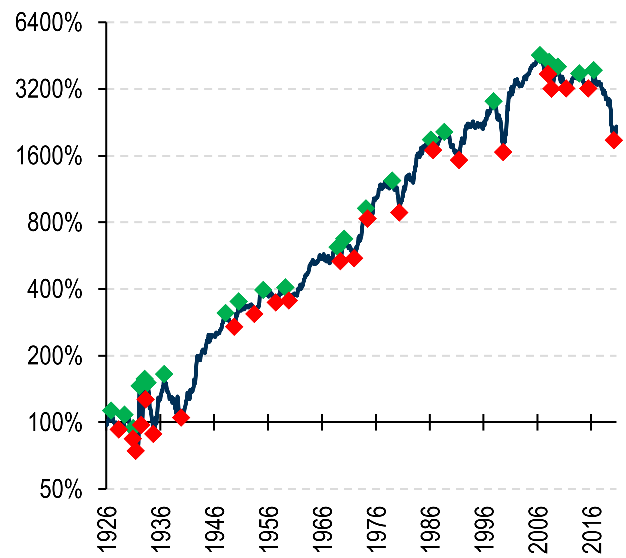
To quote the late great Freddie Mercury of Queen, we currently find ourselves asking the question, "Is this the real life? Is this just fantasy?" The first quarter of 2021 elicited two emotions that Value investors haven't felt for a long time: relief and hope. After a dismal year for our core value and income focus area within the equity market in 2020, Q1 2021 marked the largest rotation into Value since 2001, as the Russell 1000 Value index outperformed the Russell 1000 Growth index by 10.3 percentage points (+11.2% vs. +0.9%). At long last, Value factors like earnings yield and book-to-price were no longer a gale-force headwind and instead proved a boon to performance during the quarter.

The popular narrative for the switch in style preference was that of a reflationary trade, with increases in Treasury yields and inflation expectations cited as key macroeconomic catalysts for the mini-rotation from Growth to Value. We've written about this theme at length, including in our last investor letter from Q4 2020, "Green Shoots for Value." We clearly agree with that thesis but do not think interest rates will be the only variable that could drive the continued outperformance for Value stocks. Although Q1 2021 was a great quarter for our strategy, we believe it could be merely in the early innings of a years-long regime change from Growth to Value.

One of the driving forces behind our conviction is both the level and duration of the current secular bull market in Growth. If history serves as a guide, a regime change in style leadership can be an agonizing process for the incumbent strategy (see our November 2020 white paper, "The Case for Value"). We've shared with our investors many depictions of how extended we believe the current blow-off rally in Growth stocks is but forgive us for continuing to illustrate the point. In the exhibit at right, which we've borrowed from a recent Bank of America research report, you can see the current recovery in Value is still in its nascent stages, based on historical patterns. As this particular report notes, within the time period examined, Value cycles have lasted 33 months and outperformed Growth by 58 percentage points, on average. We're currently only in month seven of the Value rally, with Value stocks having outperformed Growth by 20 percentage points off the trough.[1] Based on the extent of Value underperformance over the last several years, we would anticipate that the recovery in Value could very well exceed these historical averages, leaving ample opportunity to rise from current levels.

While the case for mean reversion is compelling, we also must consider what phase of this truncated economic cycle we currently occupy. With the COVID-19 reopening underway and economic data rebounding sharply, it appears to us that the market is progressing from early to mid-cycle. While we believe cyclicals will continue to benefit from the recovery, we also think that higher-quality names and larger-cap stocks should gain from more stable economic footing. In that sense, we view today's market environment as reminiscent of the 2010–2012 time period. Then, like now, investors had just come off a roller coaster of drastic market movements, initially crashing and then bouncing off the lows with the aid of Fed-supplied monetary stimulus. As investors get their bearings and refocus on earnings stability, we believe Value strategies will continue to gain favor.

Value / Growth Performance
Cycle Peaks & Troughs
Value Cycles Typically Last 33 Months on Average and Outperforms Growth by 57% on Average



Sources: Inspiration from BofA Global Research, Fama & French, Callodine Capital Research Team
Methodology: Value/ Growth Performance = Fama & French HML factor performance. Cycles determined by 10%+ changes in performance.

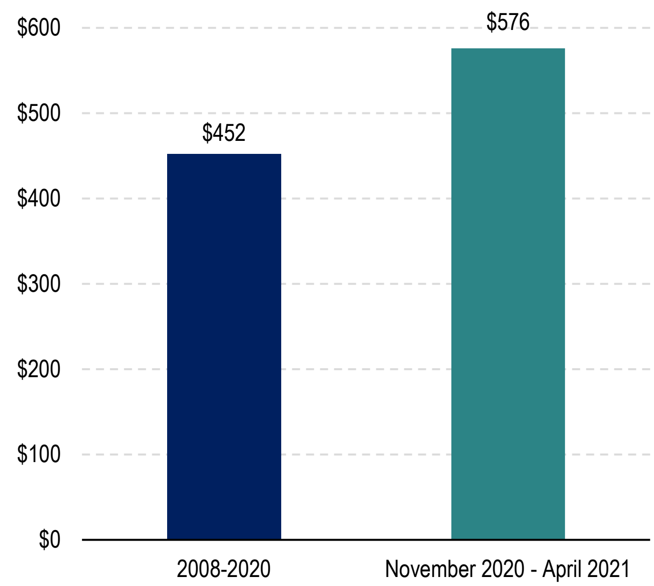
[1] Bank of America Research dated 4/16/21. "S&P 500 Relative Value Cheat Sheet - Is the Value run over?"

Liquidity Abounds

Speaking of the Fed, one key variable that we will continue to monitor as we head into the second quarter of 2021 will be market liquidity. Pinning rates at zero while simultaneously approving multiple, multi-trillion-dollar stimulus plans seems to us a foolproof way to create excess liquidity, the evidence of which is rampant and has taken many forms over the last 12-months.

Bank of America recently noted that global equities have experienced $576 billion in inflows over the past five months alone. This staggering total is more than 25% greater than the $452 billion of inflows seen in the last 12 years combined![2] Similarly, credit markets have more than completely healed from the steep re-pricing of risk associated with the onset of the COVID-19 pandemic just over a year ago. BBB-spreads to the 10-year Treasury, which had exploded from near a previous all-time low of 125bps in early 2020 to over 320bps at their wides, have now settled below 110bps recently.

Inflows Into Global Equities



Source: Bank of America and Callodine Capital Research. Dollars in Billions.

Simply put, rising asset prices are everywhere and they are causing capital to either ignore, or in many instances seek out volatility, under the assumption that high vol assets are likely to increase the most during periods of speculative excess when the Fed “has your back”.

A recent excerpt from the Wall Street Journal reflects the mood of the day:

> *Rarely have so many assets been up this much at once.*
>
> *The price of lumber has shot up to all-time highs. Residential home sales in the U.S. are at levels last seen in 2006, before the housing bubble collapsed. And stocks are on a tear. Benchmark indexes from the U.S. to France to Australia have all climbed to fresh highs this year, with the S&P 500 and Dow Jones Industrial Average recently hitting their 23rd and 21st records of the year, respectively.*
>
> *The frenzy has extended far beyond conventional markets tracked by Wall Street firms. Bitcoin hurtled above $60,000 for the first time last month before pulling back, while Dogecoin briefly jumped to a record, driven by fans posting hashtags like #DogeDay on Twitter. In the venture-capital world, investors are offering startups five times or more the amount of money they are requesting, and the average valuation for all startups has hit a new high.*[3]

While excess liquidity has flooded into and bid up nearly all financial assets, spawning “Meme stocks” and $69 million “non-fungible tokens”, crypto-“currencies” are the most obvious and largest form of outright mass speculation in our minds. At the time of this writing, there are “investors” who believe they have over $35 billion in value stored in Dogecoin. Stop and think about that for a moment. Consider the speculative froth and excess liquidity required for such a situation to occur, as well as the odds that this will end well for whoever gets caught holding the bag on this open-for-all-to-see Ponzi scheme.

In aggregate, the top 100 cryptocurrencies have a total market value of over $1.6 trillion[4], nearly ½ the size of the Russell 2000 Index. To put this into further speculative context, Americans spend roughly $70 billion annually on lotteries[5].

Calling these phenomena “currencies” is also giving them a credibility they do not deserve, as they act as neither a true medium of exchange nor a store of value. Occasionally transacting in Bitcoin is very different than widely accepted fixed price contracts, which would be a sign they are a true medium of exchange, and the daily volatility of these currencies is simply too high for them to act as a store of value.

Beyond the top 100, there are over an additional 1,000 digital “currencies” being tracked by Coinmarketcap.com, with over 400 of these valued in excess of

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[2] Reuters article dated 4/9/21. “More money poured into stocks in past 5 months than over last 12 years.”
[3] Wall Street Journal article dated 4/25/21. “Wild Market Ride Lifts Everything From Lumber to Stocks to Bitcoin” by Akane Otani and Michael Wursthorn)
[4] Website: https://coinmarketcap.com/
[5] U.S. Census. https://www.census.gov/data/tables/2017/econ/state/historical-tables.html

$1 million. With over 87% of global trade conducted in just three currencies and over 90% of global currency reserves held in just two (the US Dollar and the Euro) it's hard to imagine a future economic system that is in need of over 1,000 digital currencies.

We write about cryptocurrencies not because they pose any significant systemic threat to the economy in our minds, but because they represent an obvious manifestation of too much capital chasing too few speculative assets in the world; a backdrop where getting paid properly to take risk is incredibly hard to come by. It remains to be seen what happens when the drug of excess liquidity is removed from the system and whether it will result in any symptoms of withdrawal. Will it cause inflation, or can you stimulate your way through a cycle with no ill effects? We believe this singular factor will be the most critical one to consider around both the direction and tenor of equity markets for the foreseeable future.

So Where Are You Paid to Take Risk?

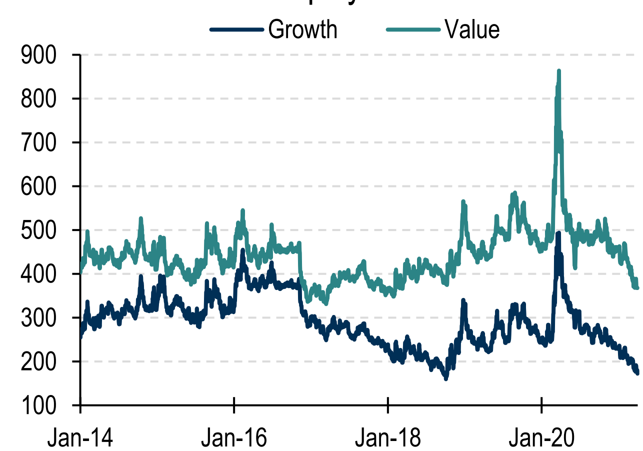
One metric we think is worth analyzing in the context of the current environment is the equity risk premium (ERP) being assigned to certain segments of the market. While the risk premium of the broader U.S. equity market has been significantly reduced over the last two years, and the last 12 months in particular, there has been a bifurcation between the ERP of Growth and Value stocks. As shown in the table below, the ERP of Growth stocks has declined to less than 200 basis points (bps), back to levels consistent with its levels before the sharp selloff in Q4 2018. By contrast, the ERP of Value stocks has contracted, but not nearly as sharply, remaining in the 400 bps range and more than two full percentage points higher than Growth stocks.

If we frame that risk premium in the context of the broader fixed-income market, Value stocks are generating an earnings yield premium over Treasuries roughly equivalent to the credit spread on CCC rated bonds. We view this risk-reward proposition as highly attractive, particularly given the duration risk inherent in the high yield market and the upside we see to valuation multiples within the Value segment of the equity market.

Another area of the market that we think has lost significant favor since the onset of the pandemic is stocks that experience low volatility. In the exhibit below, you can see that the valuations of Growth stocks have continued to increase relative to the broader S&P 500. This is not a new theme, particularly for those of you that have read our previous market commentary. What is most striking is the drubbing that low volatility stocks have taken since Q1 2020. Even more than stocks exposed to the Value factor, U.S. equities that have lower realized volatility have been forsaken for high vol, speculative stocks. Perhaps this shouldn't come as a surprise given the speculative climate we covered above, but low volatility stocks have suffered mightily on a relative basis. They lack the excitement required to garner attention in this environment, and similarly lack a "story" tied to either recovery or secular growth seemingly favored by most current market participants.

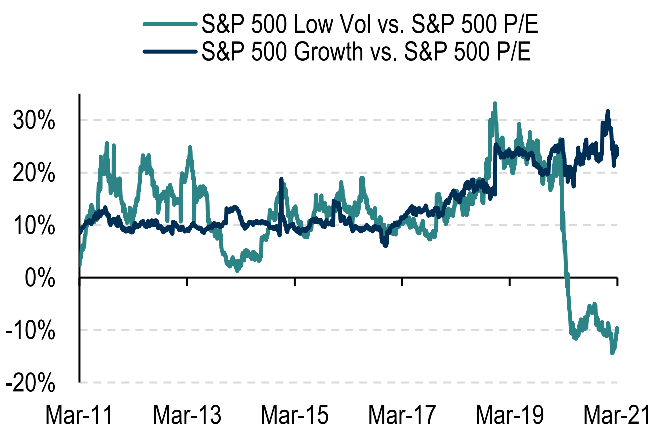
These stocks simply produce consistent cash flows at incredibly attractive valuations, in a world where the allure of such simplicity is lost chasing non-cash producing assets which continue to proliferate. Unlike parts of the Value universe, low-vol stocks have experienced no love whatsoever of late, and as such represent to us the most intriguing opportunity in equity markets, broadly speaking.

US Equity
Next Twelve Month Equity Risk Premium



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Equity Risk Premium = NTM EPS Est / Price - 10 Yr US Treasury Yield. Daily observations from Jan 1, 2014 through Mar 31, 2021. NTM EPS Est = Blend of FY1 and FY2 bottoms up estimate. Growth = Russell 1000 Growth

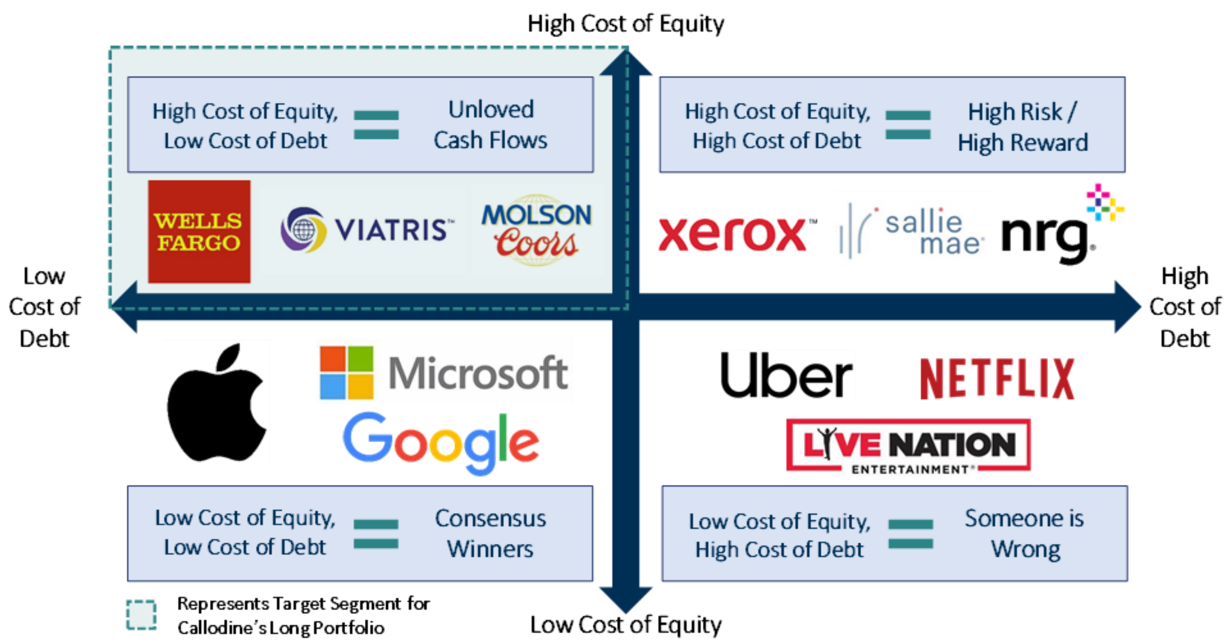
Low Volatility & Growth Relative Forward Valuations



Sources: Inspiration from Jefferies Trading Desk, Bloomberg, Callodine Capital Research Team
Methodology: Blended forward P/E estimate for S&P 500 Low Volatility Index (SP5LVI) and S&P 500 Growth Index (SGX) vs. S&P 500 Index (SPX). Daily observations from March 31, 2011 through March 31, 2021.

Equivocation in the Capital Markets

One way to identify these companies is around a theme we touched upon in our aforementioned white paper, "The Case for Value," namely the inconsistency with which debt and equity markets are assigning risk to the same issuer. An illogical and inexplicable discrepancy in a company's cost of capital continues to be a hallmark that we look for in identifying mispriced stocks with low risk and high upside potential. In the exhibit below, we've highlighted one of the lenses through which we view the current equity market:



Source: Bloomberg, Callodine Capital Research Team. This exhibit is a depiction of Callodine's proprietary and subjective view of the market. The investment examples should not be considered a recommendation to buy or sell any specific securities.
Note: "Low" cost of debt companies have investment grade rating whereas "High" cost of debt companies have below investment grade rating. Breaking point for "High" vs. "Low" cost of equity deemed to be 20x 2021 P/E Multiple. Classifications represent Callodine's internal views.

The examples provided within these four quadrants are not intended to pick on any one stock in particular, but rather to serve as an illustration of how we view the current field of play. To summarize our perspective on each category:

> Unloved Cash Flows (upper left) – This is the area of the market where we prefer to reside and where we see considerable opportunity in the current environment. The debt markets are confident about the risk that these companies present, and yet equity participants remain unimpressed. These stocks can be purchased at attractive cash yields in an expensive world, with what we perceive to be limited downside based on current valuations.
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> High Risk/High Reward (upper right) – Buyer beware. These companies have fallen from grace and may or may not represent fundamentally flawed business models. We view the investment outcome as binary and generally carrying considerable risk.
>
> Someone Is Wrong (lower right) – The equity market loves these companies, but the debt market is skeptical, and they are typical high yield issuers based on credit metrics. This has been perhaps the most frustrating quadrant of the market for Value investors, who are generally more inclined to side with the debt markets on these names. These stocks have largely flourished over the last 12 months, and we believe that a repricing may be overdue.
>
> Consensus Winners (lower left) – Everyone loves these stocks, as they should (up to a price). These companies are the darlings of both the equity and debt markets and represent stable, growing businesses that command premium valuations and low credit spreads. This is the mostly highly (overly?) owned part of the equity market currently and is priced for near perfection.

As long as the equity market continues to assign free-cash-flow yields to investment-grade companies that are anywhere between 300 and 500 bps over that company's cost of debt, we will continue to view those names as highly attractive from a risk-reward perspective.

Reasons for Continued Optimism

Despite the double-digit rally in Q1 2021, we continue to believe that the Value and Income segments of the U.S. equity market represent an incredibly attractive area of the broader investment landscape for three main reasons:

1. A significant portion of the stable, cash-flowing stocks that we favor have not yet participated in almost any of the upside enjoyed by the broader equity market over the last 12 months.

2. Certain U.S. equities continue to provide attractive cash yields in an environment where it has become increasingly difficult to identify reliable sources of investment income without taking significant credit and/or liquidity risk.

3. Certain Value sectors may be better positioned for relative growth and positive earnings revisions than traditional Growth sectors.

The concept of yield at a reasonable price (YARP) may seem like a term of a bygone era to fixed-income managers or institutional allocators, but we believe this investment style can be deployed in the current equity market environment with tremendous success.

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