CALLODINE | CAPITAL

Quarterly Market Commentary
Q3 2022

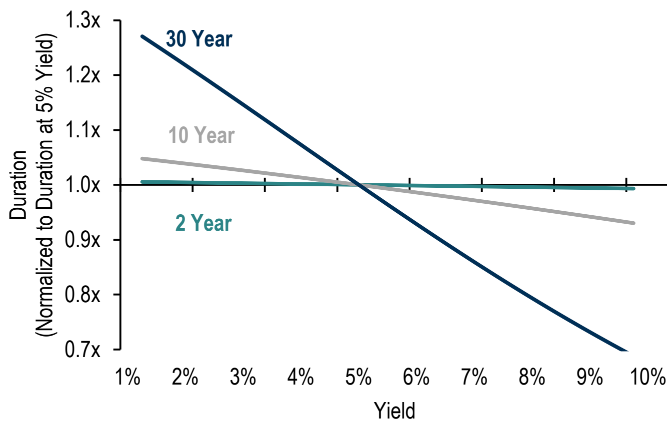
"When Nothing Turns into Something"

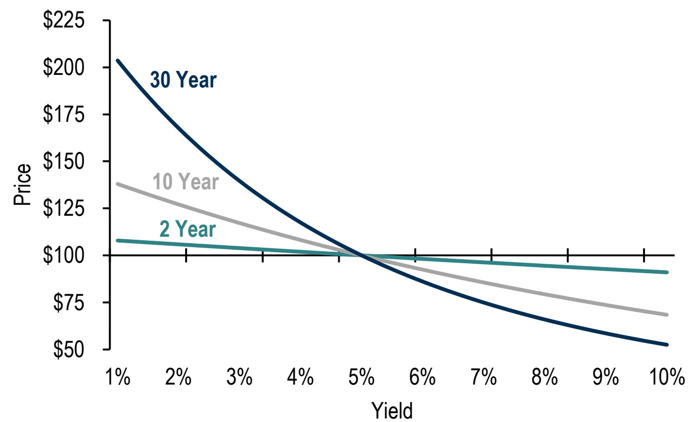
Market Commentary

Many investors would consider duration to be solely a bond market concept. Investopedia tells you that “duration measures a bond’s or fixed income portfolio’s price sensitivity to interest rate changes.” The second-derivative cousin of duration is convexity, which is a measure of the change in a bond’s duration as prevailing yields change (i.e., its change in sensitivity to interest rate movements).

Impact of Convexity on Bond Duration and Prices

Bonds with Different Maturities and 5% Coupon





Sources: Bloomberg, Callodine Research Team.

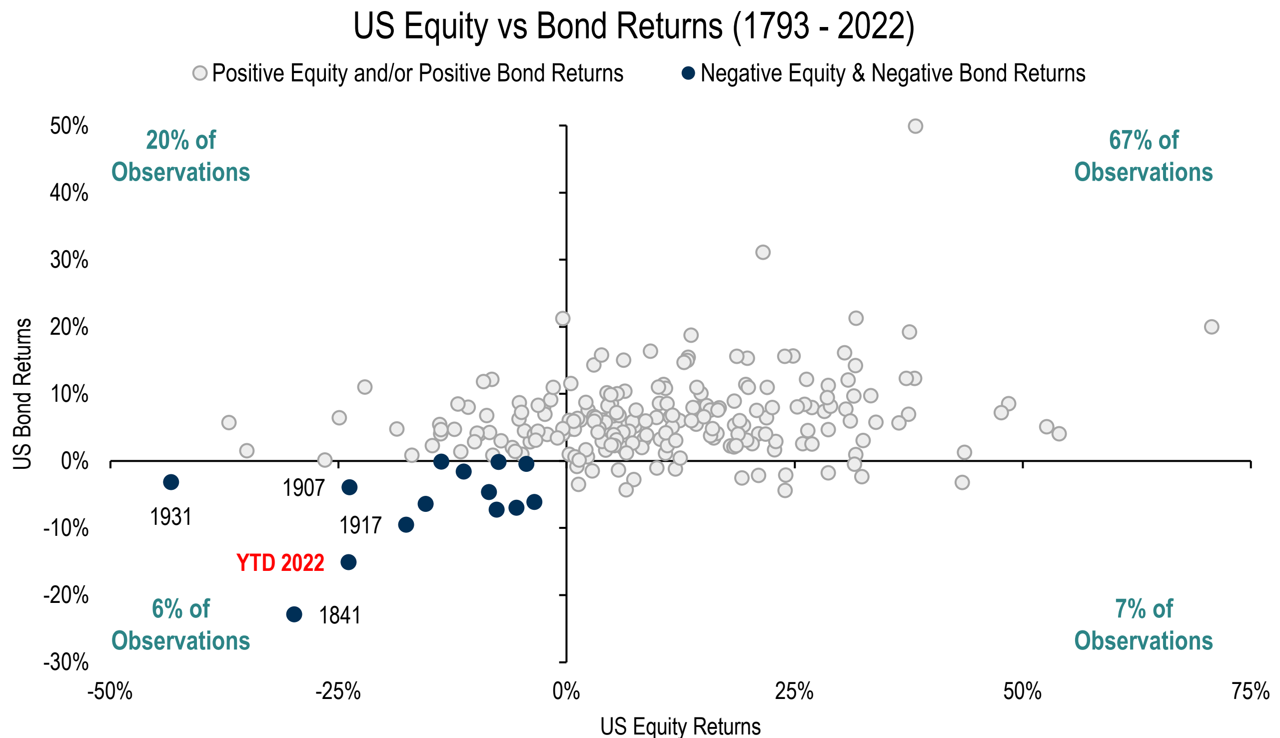
These concepts are core to fixed income investing, but the notion of duration can really be simplified to how long it will take for investors to realize and receive the value associated with their investment. Using that idea, duration can apply to any investable asset class, including public equities.

The duration of an equity security can be measured by when investors can expect to realize the value of their investment and the timing of the associated cash flows. Much like a bond, equity securities that return a significant amount of cash shortly after purchase can be considered “short duration” assets when compared to a non-cash-flowing equity security or one where all of the projected value resides in some assumed terminal value far into the future. This makes growth stocks similar to zero-coupon bonds, where all of your value comes at the end.

In this quarterly letter, we will further explore this concept and its potential implications for the U.S. equity market.

“60/40” Hits a Speed Bump at 100 MPH

Both equity and fixed income markets have gotten a lesson in duration during 2022. Heading into the year, both equity and bond markets were at record-high duration levels, seemingly sanguine about the potential risk that interest rates could ever move materially higher. This confident positioning ignored the growing inflation problem beneath the surface of the economy. So instead of the calm year implied by this fact pattern, we have witnessed one of the worst performances over the last two hundred years for the vaunted 60/40 blend portfolio, with U.S. equity returns at -23.9% and bond returns at -15.1% year to date through September. Only in 1841 did investors see a more dismal 60/40 asset level return, according to our research. [1]



Sources: Edward F. McQuarrie, Robert Shiller, Ibbotson SBBI, Bloomberg, Callodine Capital Research Team.
Methodology: Annual Returns, with 2022 through September 2022. US Equity Returns are composed of McQuarrie Nominal Stock Return from 1793 through 1870, Shiller S&P Comp. Return from 1871 through 1925, Ibbotson® SBBI® US Large-Cap Stocks (Total Return) from 1926 through 1989, and Bloomberg S&P 500 Return from 1990 through September 2022. US Bond Returns are composed of McQuarrie Nominal Bond Returns from 1973 through 1925, the average of Ibbotson® SBBI® US Long-term (20-Year) Corporate Bonds (Total Return), Ibbotson® SBBI® US Long-term (20-Year) Government Bonds (Total Return), and Ibbotson® SBBI® US Intermediate-term (5-Year) Government Bonds (Total Return) from 1926 through 1972, and Bloomberg US Government/Credit Bond Index from 1973 through September 2022.

Driven by a series of rate increases by the Federal Reserve, the 3-month Treasury Bill yield has moved from 0.07% to just over 4.0%, the same yield you would have earned a year ago to take on BB-rated credit risk.

Suddenly nothing has turned into something as far as the risk-free rate is concerned.

This phenomenon has caused gravity to return to markets everywhere and each asset class is rediscovering the laws of physics in its own distinct way. We’ve used the analogy in the past that the Fed is like the sun of financial markets, and asset classes that orbit near it (such as Treasuries and Agency mortgage-backed securities) react very quickly to changes in its gravitational pull, and as a result have repriced themselves in short order. However, the further you get from the Fed’s direct sphere of influence, the slower and more uneven that price discovery function may be. Credit and equity markets are attempting to sort themselves out right now as they grapple with an inflationary backdrop during the onset of a potential recession for the first time in over 40-years.

For digital currency “investors” living out near Neptune, the Fed’s message may not have yet fully arrived.

[1] For U.S. history buffs, 1841 was a year where the United States had three presidents: Martin Van Buren, John Tyler, and William Henry Harrison, who died exactly one month after taking office. In addition, Arkansas, Illinois, Indiana, Mississippi, Pennsylvania, and Florida all defaulted on their state debt obligations. 1841 was a tough year!

The core problem for equities, and in particular for long duration growth stocks, is the starting point from which this re-pricing needs to occur. Much like the bond market, where duration moved to all-time highs and yields to all-time lows, growth stock cash yields were also pushed to levels not witnessed outside of the very peaks of the 2000 cycle.

In contrast to their long duration brethren, value stocks and their far shorter duration cash yields never extended during the post-COVID era and remain near 10-year highs in terms of cash yields.

Where's the Cash Flow?

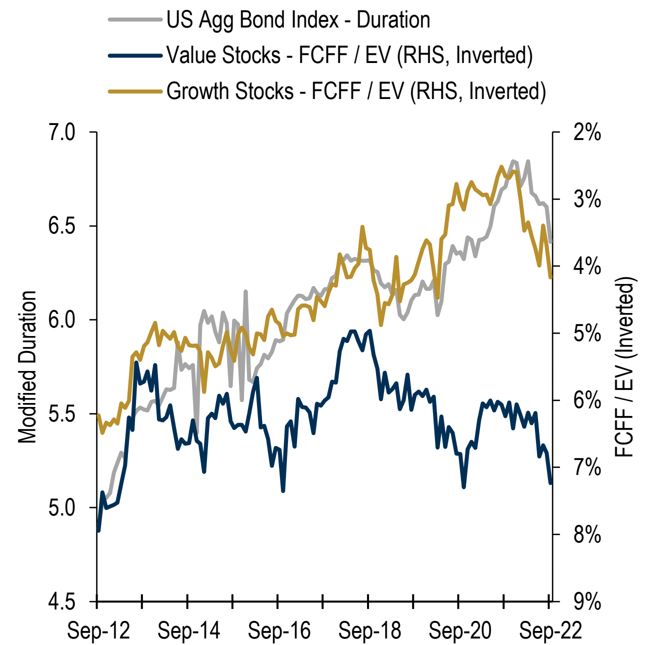
With 4-5% yields now suddenly available to investors in the form of "risk-free" U.S. Government securities, the ante has been raised for all competing investments, including stocks.

As cross asset investors compare the newly cash yielding opportunity set, combined with the suddenly questionable real growth outlook, those names that have built business models dependent on cost-free capital, or those that require 100% of their free cash flow to maintain inflated growth rates, the bill has suddenly come due, and their relative attractiveness has come into question.

The chart on the bottom right captures this point clearly in our view, as it shows the % of growth universe market cap that now generates a Free Cash Flow ("FCF") yield less than the prevailing 5-year Treasury.

How long could this persist, and how much further could Long Duration Growth have to fall to adjust to this new interest rate paradigm? This is where convexity and duration become important stock market concepts.

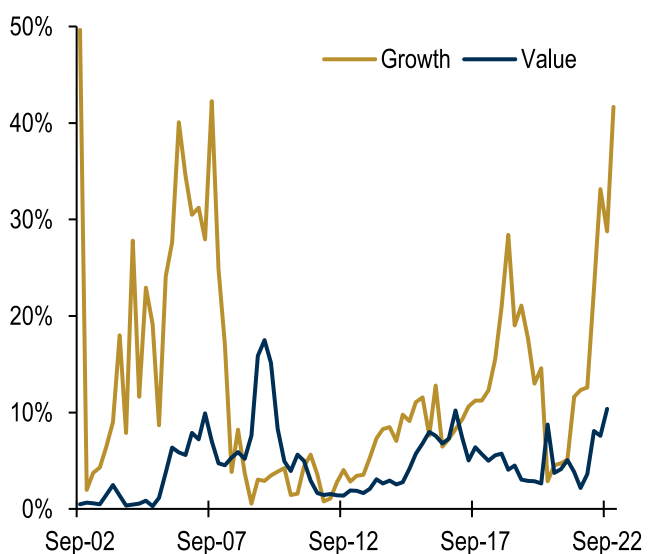
Bond Duration and Free Cash Flow to EV



Sources: Bloomberg, Callodine Capital Research Team.
Methodology: US Agg Bond Index is represented by the Bloomberg US Agg Index. Growth companies are constituents of the Russell 1000 Growth Index that are not constituents of the Russell 1000 Value Index. Value companies are constituents of the Russell 1000 Value Index that are not constituents of the Russell 1000 Growth Index. FCFF / EV is the EV weighted FCFF / EV of companies with available data.

> 40% of Growth Market Cap Yields Less than 5Yr

% of Market Cap with Fwd. Earnings Yield Less Than US 5Yr Treasury



Sources: Bloomberg, Callodine Capital Research Team.
Methodology: Growth companies are constituents of the Russell 1000 Growth Index that are not constituents of the Russell 1000 Value Index. Value companies are constituents of the Russell 1000 Value Index that are not constituents of the Russell 1000 Growth Index.

So Where Are We Now? An Unpopular View to Follow:

I recently had lunch with a group of equity investors here in Boston. We compared notes on the market, and our discussion helped serve as a useful gauge of how investors with different styles are currently thinking about the state of the economy and financial conditions more broadly. During the conversation, I observed that certain growth stocks had "corrected somewhat" but may still have a considerable correction ahead before they find their bottom, to which a Growth-oriented manager replied, "Only a Value investor could say that Growth has only corrected *somewhat*."

Although the recent sell-off in Growth stocks may have been painful, it is important to put recent market action in perspective over a longer time horizon.

This observation is based not only on our perspective, but by using the prevailing data of the last nearly two decades, an era dominated by Growth investing styles. Investors are currently grappling with the distinct possibility that the "Playbook" which worked so well for so long has suddenly stopped working at all.

As of this writing, we are witnessing a most remarkable Q3'22 earnings season, where the market is +8.9% MTD[2] despite disappointing earnings, declining out year earnings expectations and significant stock underperformance by Microsoft, Google, Amazon and Meta, among others. This is the Great Rotation we discussed in our Q1 2022 quarterly letter continuing to grind its way through the market, destroying the old construct and tossing aside the "Secular Growth" playbook with which so many investors had gotten so comfortable. It's hand-to-hand combat now in markets, with the "easy trade" no longer in place.

The underlying problem in all of this remains the starting point. Profit pools and investors' dreams have both aggregated heavily into the Technology sector over the last 10 years, resulting in it coming to dominate market performance to an extent only witnessed during the last Tech Bubble in 2000.

Whenever "this" happens we hear that "it's different this time", that the enthusiasm for "the Cloud" is very different than the prior mis-pricing of enthusiasm for "the Internet" proved to be. That SAAS software will live in a world radically different than the Enterprise software it displaced, and that the semiconductor sector has left behind the nasty cyclical behavior of the past is complete fallacy.

All of that may have felt possible with a 10-year tailwind from free capital fueling investment in cash-burning enterprises, and to question any of this as a Value Investor was seen as both lazy and luddite-like behavior only 10-months ago.

Roll-Over in Tech is Small in the Big Picture

Tech vs S&P 500 Price Relative

Sources: Kenneth R. French, Bloomberg, BofA Global Investment Strategy, Callodine Capital Research Team.
Methodology: Ratio of Tech Price Return Index to S&P Index Price. Monthly Data from Dec 1927 through Sep 2022. Tech Price Return Index is comprised of the return for the "HiTech" Industry Portfolio [ex. Dividends] from Dec 1927 through Sep1989, and the price return for the S&P 500 Information Technology Sector GICS Level 1 Index from Oct 1989 through Sep 2022.

In our minds, new technologies will always supplant the old, it is what makes creating and sustaining profit pools in Technology sector so difficult over long periods of time. At times, the market reminds us of this violently, Nokia met the iPhone and faced its rapid demise, Facebook has suddenly been Tik Tok'ed into crisis. These things happen frequently in Technology, where the only seemingly sustainable profit pools tend to be monopolies hiding in plain sight (we see you Microsoft, Google and Apple), otherwise business models can feel like they the half-lives of a fruit fly in hindsight.

Most of the time you are trading rapid growth for ultimate uncertainty, and if it feels like you are not as a Growth investor, well once again call us skeptical given the nature of markets over time. As rates were taken to zero during the earliest phase of the pandemic, this tension between greed and fear was lost, cash yields in Growth fell dramatically, creating a spread to Value not witnessed during the prior +25 years. The explanation for this was typically interest rates, and "TINA" there is no alternative. But now, there might be.

[2] S&P 500 performance for the month of October, through October 28, 2022.

In It for the Duration

At Callodine, we obsess over a company's ability to generate cash. FCF yield to the Enterprise is probably the single most important metric that we evaluate when assessing whether we want to own a company in our portfolio. Unfortunately, until recently, cash flow generation has taken a back seat to anticipated revenue growth in the hierarchy of investor preferences. They are not the same thing, as some investors are rudely discovering at the moment.

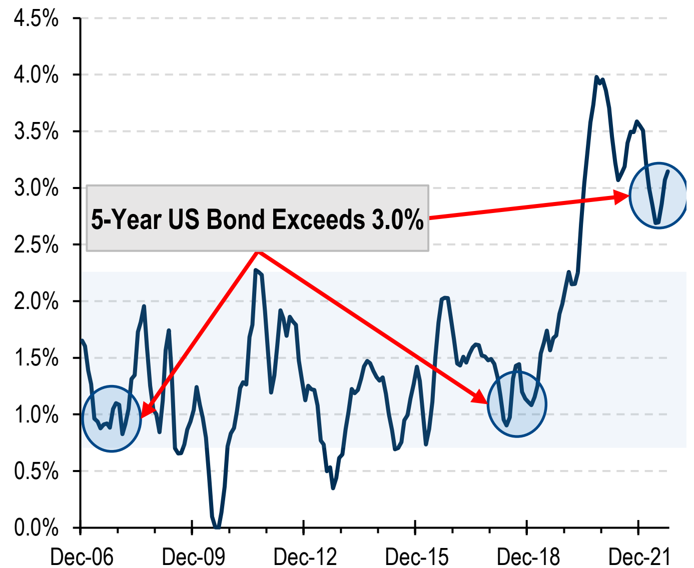
So while Value is enjoying its first run of sustained outperformance in over fifteen years, we believe it is quite accurate to say Growth names have only corrected "some". There remains an unexplained premium embedded in these stocks that is slowly grinding its way out of the prevailing relative valuation between the two styles. This is duration at work in the equity market, and we don't believe this cycle will be complete until that premium has been completely wrung from long duration Growth names.

Markets and companies alike need liquidity to function properly. For the last two-plus years, the Fed supplied ample liquidity to financial markets, while near-zero rates allowed corporate issuers to access seemingly unlimited liquidity via the capital markets. Neither circumstance persists today. As a result, we believe that companies that can generate their own liquidity via FCF will be best positioned to flourish in the current environment.

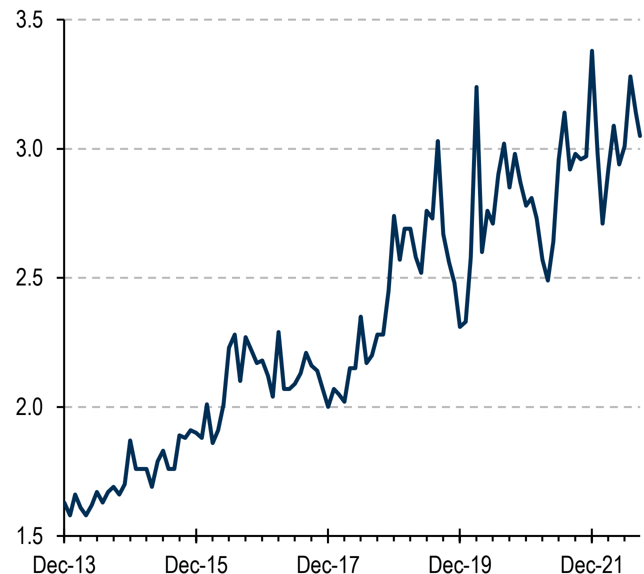
While we have been writing about the Growth versus Value debate for many quarters, we've recently begun to focus our attention and conversations with investors around the concept of high- versus low-duration stocks. While not identical concepts, the overlap between Growth and Long Duration versus Value and Short Duration is considerable.

But looking at stocks solely along the duration vector does eliminate some factor bias that might color the traditional Growth vs. Value conversation. It focuses on the timing of cash flows, versus the growth of those cash flows over time.

Interestingly, through this lens the story is the same in terms of where we are, and where we might be heading in equity markets if interest rates remain elevated for some time. The chart to the right illustrates the lack of any meaningful correction for long duration names on a relative valuation basis, as their premium remains near 10-year highs, despite the complete change in the underlying interest rate environment.



Sources: Bloomberg, Callodine Research Team.
Methodology: 3 Month Average Spread in the FCFF/EV of Growth companies – Value companies. Growth companies are constituents of the Russell 1000 Growth Index that are not constituents of the Russell 1000 Value Index. Value companies are constituents of the Russell 1000 Value Index that are not constituents of the Russell 1000 Growth Index. FCFF / EV is the EV weighted FCFF / EV of companies with available data.



Sources: Bloomberg, Callodine Research Team.
Methodology: Russell 1000 High Duration Forward P/E is the median forward P/E of the highest quintile of Russell 1000 constituents based on duration as calculated by Bloomberg. Russell 1000 Low Duration Forward P/E is the median forward P/E of the lowest quintile of Russell 1000 constituents based on duration as calculated by Bloomberg.

One explanation is that while bond markets understand the concept of convexity, the equity market and in particular, owners of long duration equities have not yet seemed to grasp this concept. This may all take some time to sink in, but we see no logical argument that would justify a continuation of the status quo in such a starkly different economic landscape than the one that preceded it.

Specifically, the convexity of the technology sector seems to be entirely lost on the market. Simple discount-rate math should have caused a far bigger drop in many of the names based on the expected timing of their underlying cash flows, which are often projected into the distant future.

To date, the performance of short- versus long-duration stocks and the benefit of owing short-duration assets in a rising rate environment is why we are cautiously optimistic about the area of the market in which we traffic. Short-duration assets were punished in the post-pandemic market run up, but so far are not getting much relative benefit from acting as a safe harbor during a higher interest rate regime.

At Callodine, we believe this is as cheap as Value and shorter-duration equities have looked in a very long time. While there will almost certainly be continued volatility on the horizon, given the level of uncertainty surrounding the broader economy and the path of interest rates, today we are able to purchase strong and stable cash flow–generating businesses as single digit price/earnings multiples and low-double-digit FCF yields.

In closing I will highlight an article I recently read which cited Walter Bagehot, the British journalist and businessman, from the mid-1800's:

> **"It is a fact of experience that when the interest of money is 2% (or less), capital habitually emigrates and is wasted on foolish speculations, which never yield any adequate return. If the old, tried, and safe investments no longer yield their accustomed returns, we must take what they do yield, or try what is untried. We must either be poorer or less safe; less opulent or less secure."**[3]

What we have now is the reversal of that process, where tried and true yielding investments suddenly hold great appeal relative to suddenly discredited "New New Things" which have turned out to need an endless supply of free capital to make the gears turn.

When Treasury yields go from nothing to something, a lot changes, and it takes time for markets to digest and recalibrate. This is a process we believe has only just begun.

---

[3] https://collabfund.com/blog/handle-hard-well/

Disclaimer

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by Callodine Capital Management, LP (“Callodine”) to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information’s accuracy or completeness, nor should the attached information serve as the basis of any investment decision.

Past performance is not an indication of future results.

The views expressed reflect the current views as of the date hereof and neither the author nor Callodine undertakes to advise you of any changes in the views expressed herein. It should not be assumed that the author or Callodine will make investment recommendations in the future that are consistent with the views expressed herein, or use any or all of the techniques or methods of analysis described herein in managing client accounts. Callodine and its affiliates may have positions (long or short) or engage in securities transactions that are not consistent with the information and views expressed in this presentation.

This analysis is for illustrative purposes only. This material is intended for informational purposes only and should not be construed as legal or tax advice, nor is it intended to replace the advice of a qualified attorney or tax advisor. The recipient should conduct his or her own analysis and consult with professional advisors prior to making any investment decisions.

Index returns and other investment products cited within are provided to show an example of return potential during the relevant time periods. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index. The S&P 500 is a market capitalization weighted index of large-capitalization U.S. equities that includes 500 of the top companies in leading industries of the U.S. economy. The Russell 1000 Growth Index measures the performance of the large-capitalization growth segment of the US equity universe and includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of the large-cap value segment of the US equity universe and includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. Tech Price Return Index is comprised of the return for the "HiTech" Industry Portfolio [ex. Dividends] from Dec 1927 through Sep1989, and the price return for the S&P 500 Information Technology Sector GICS Level 1 Index from Oct 1989 through Sep 2022. The “Hi Tech” Industry Portfolio is comprised of Fama and French Industry Portfolio data. Fama and French Industry Portfolio data assigns each NYSE, AMEX, and NASDAQ stock to an industry portfolio at the end of June of year t based on its four-digit SIC code at that time. (Fama and French Industry Portfolio data uses Compustat SIC codes for the fiscal year ending in calendar year t-1. When Compustat SIC codes are not available, Fama and French Industry Portfolio data uses CRSP SIC codes for June of year t.) Fama and French Industry Portfolio data then computes returns from July of t to June of t+1. “Hi Tech” Industry Portfolio is represented by companies with SIC codes 3570-3579, 3622-3622, 3660-3692, 3694-3699, 3810-3839, 7370-7391, and 7373-7373, 7374-7374, and 8730-8734. The S&P 500 Information Technology is a float-adjusted market cap weighted index comprised of those companies included in the S&P 500 that are classified as members of the GICS information technology sector. The Bloomberg US Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

All projections contained herein represent our current beliefs and should not be construed as recommendations or a guarantee of future results.