

# CALLODINE | CAPITAL

## “Growth, Value, and the Power of Expectations”

Quarterly Market Commentary: Q4 2025

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# Market Commentary

We took a solemn oath not to write about anything associated with A.I. this quarter, as this topic has dominated the market zeitgeist all year. But, in a tangential way, it sets up an interesting conversation about growth, value, and performance relative to expectations. To that end, we decided to take a look at 25 years of data focusing on these factors.

Investing comes down to three primary considerations—two known variables and one unknown variable:

1. What are the short-term and long-term expectations for a company (i.e., growth)?
2. How likely is the company to meet, beat, or miss its performance expectations?
3. How is the combination of risk and reward being valued by the market (i.e., value)?

In some sense, growth and value are easily observable in the market, as both consensus growth expectations and valuations can be readily obtained. It is performance relative to expectations where the action tends to occur. Which companies will surprise us?

Consider a game of blackjack, where both your hand and the dealer's hand are showing. Your conviction about your bet and course of action comes from understanding the probability of winning or advancing your odds based on the next card, given those two known starting points.

Investing is similar, as both growth and value matter, even if the market seems to have forgotten about valuations mattering of late. Nevertheless, understanding your probabilities of success from where you're starting matters most of all.

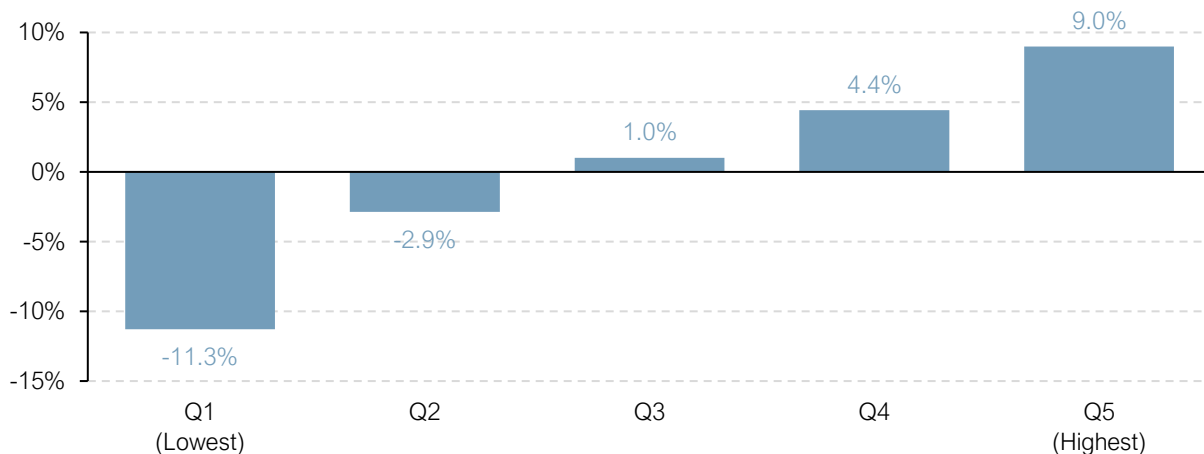


# Preferring a Low Bar to a High One

The most ideal “strategy” for investing is to have perfect foresight and know exactly which companies will grow the fastest. This approach would work incredibly well, if only it were possible to implement. The fallacy of having perfect foresight is the siren song of investing in many ways.

## Average Relative Return of Perfect Foresight 12 Month Earnings Growth

Average 12 Month Forward Relative Returns by Perfect Foresight 12 Month Earnings Growth Quintile<sup>1</sup>



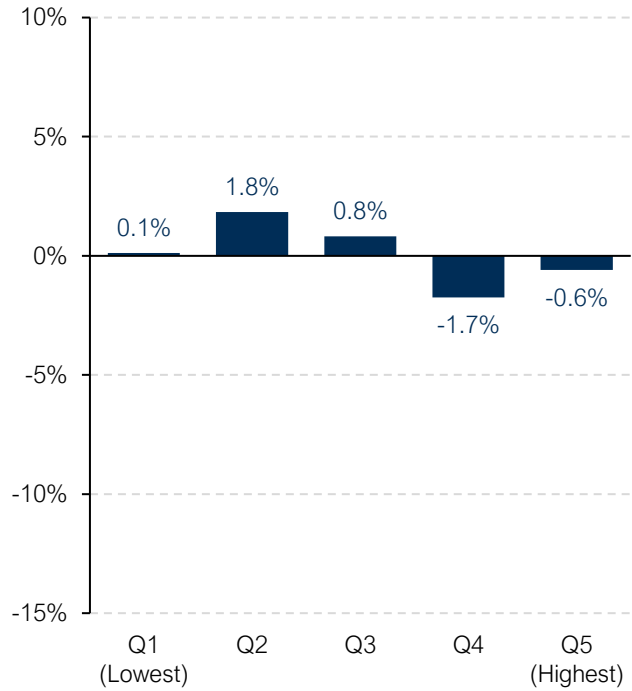
Therefore, it may be tempting for investors to simply load up on stocks that are *expected* to be the fastest growers in an attempt to beat the market—in other words, stick with the names that consensus has already ordained as winners.

<sup>1</sup> Sources: FactSet, Callodine Capital Research Team. Methodology: The analysis includes the largest 1000 US companies by market cap (US Top 1000) that are traded on a US exchange, have a primary geographic risk of US, have a stock price greater than or equal to \$2.00, do not have “LP” or “L.P.” in its name, have filed a 10Q in the past 180 days, and have non-zero volume on all trading days in the past 6 months. The universe is generated twice per year on December 31st and June 30th. Quantiling is conducted annually on April 30th from April 30th, 2000 through April 30th, 2024. Returns are calculated annually from April 30th, 2000 through April 30th, 2025. For companies with more earnings per share (EPS) estimates than funds from operations per share (FFO) estimates, EPS is used as the earnings metric, otherwise FFO is used. For companies with a fiscal year that end prior November 15th, the fiscal year 2 (FY2) estimate is used as the “Forward Earnings Estimate”, otherwise the fiscal year 1 (FY1) estimate is used. For companies using the FY2 estimate as the “Forward Earnings Estimate”, the “Latest Earnings Actual” is the FY1 estimate. For companies using the FY1 estimate as the “Forward Earnings Estimate” where the latest fiscal year (FY0) earnings is already reported, the FY0 earnings used as the “Latest Earnings Actual”. Otherwise the FY0 earnings estimate is used as the “Latest Earnings Actual”. The “Forward Earnings Actual” is the fiscal year end aligned “Forward Earnings Estimate” taken 12 months in the future. “Estimated Earnings Growth” is calculated as (“Forward Earnings Estimate” - “Latest Earnings Actual”) / abs (“Latest Earnings Actual”). “Perfect Foresight 12 Month Earnings Growth” is calculated as (“Forward Earnings Actual” - “Latest Earnings Actual”) / abs (“Latest Earnings Actual”). “NTM Earnings Yield” is the next 12 month earnings estimate / price. “Earnings Surprise” is based on the Standardized Unexpected Earnings (SUE). SUE values less than -0.5 are “Earnings Miss”, SUE values between -0.5 and 0.5 are “Earnings Inline”, and SUE values greater than 0.5 are “Earnings Beat”. SUE is calculated as the (“Forward Earnings Actual” - “Forward Earnings Estimate”) / the standard deviation of “Forward Earnings Estimates”. If a company does not have an “Estimated Earnings Growth”, “Perfect Foresight Earnings Actual”, “Earnings Surprise”, or “NTM Earnings Yield” metric, they are not included in the quantiling based on that metric, but their returns are used in generating the average return. Where returns are not available for the full 12 month period, partial monthly returns are used. Relative returns for each company for each year is calculated as the company return less the average return of all companies over the 12 month period. The quantile returns are the average company relative return in the quintile. Quantiling is un-weighted.

Unfortunately, although this approach has been working well lately in a momentum-driven, valuation-agnostic market, it has a dubious longer-term track record. The chart to the right shows the 12-month forward relative returns based on expected earnings growth quintiles. Somewhat counterintuitively, this exhibit shows that there is not a clear relationship between excess returns and estimate earnings growth quintiles.

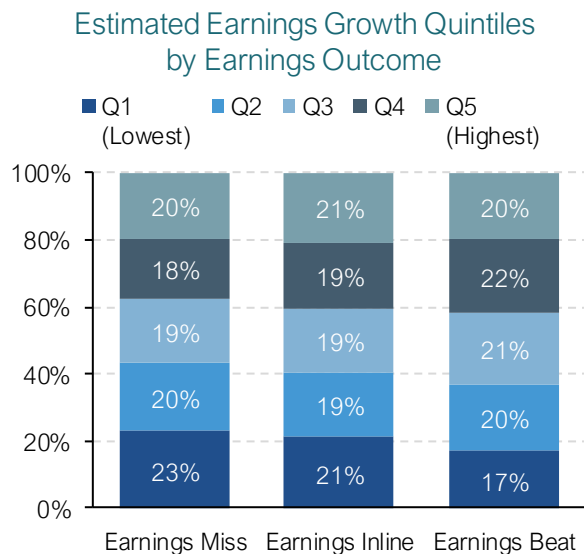
Wouldn't the fastest growers be more likely to produce positive surprises and therefore bypass the problem of the unknown variable? Well, yes, they do—but just slightly. Ultimately, both misses and beats arrive nearly evenly from all quintiles of expected growth, with companies having high expectations being only slightly more likely to beat.

**Average Relative Return of Estimated Earnings Growth**  
Average 12 Month Forward Relative Returns by Estimated Earnings Growth Quintile<sup>1</sup>



### Earnings Surprise by Estimated Earnings Growth vs Estimated Earnings Growth Quintile by Earnings Surprise

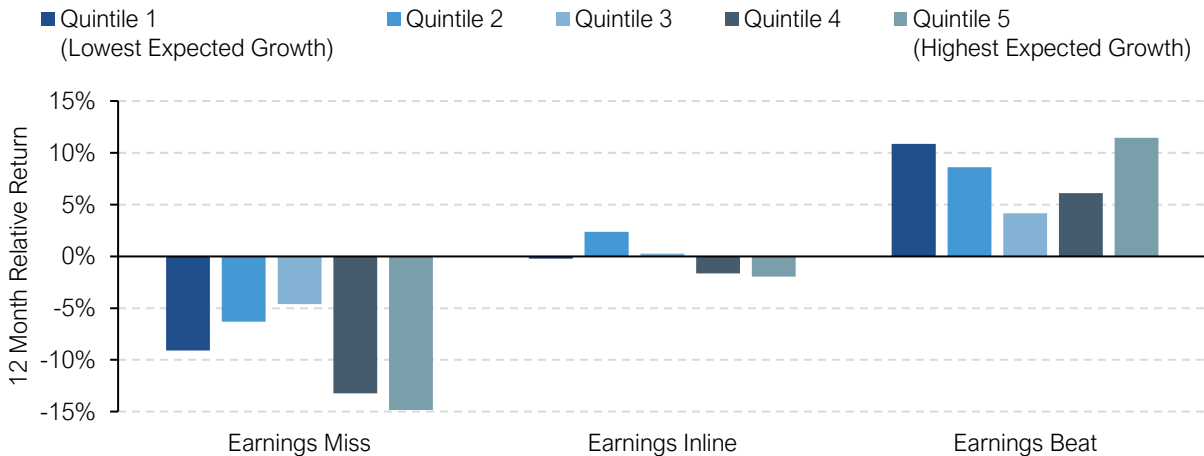
Percent of Universe by Outcome and Estimated Earnings Growth Quintiles<sup>1</sup>



Herein lies the rub for our growth-focused counterparts, high expectations matter a lot when it comes to rewarding or punishing earnings surprises. In the end, this net effect on performance swamps the slight positive skew you get from owning names with high growth expectations. So, while it feels better to win more often, the losses tend to be quite steep when they occur, and, rest assured, they will occur.

### Higher Expected Growers that Miss Estimates are Punished More

12 Month Relative Performance by Expected Earnings Growth Quintiles and Earnings Surprise<sup>1</sup>



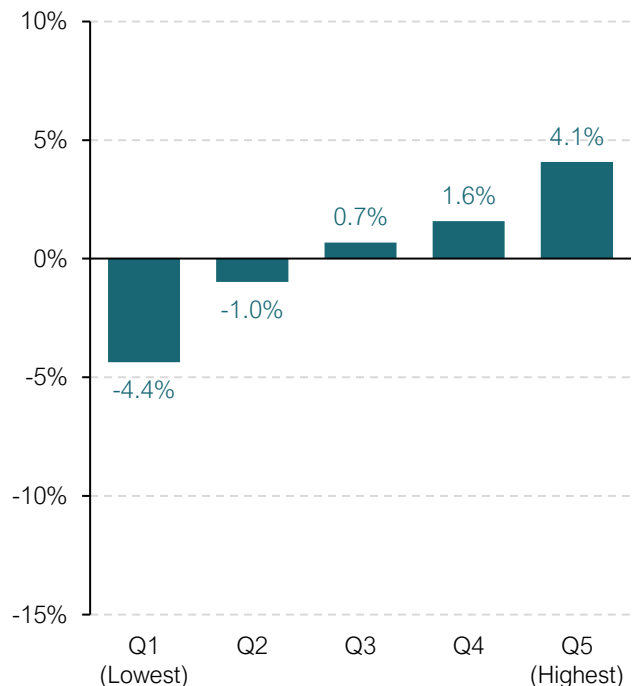
### Does Value Even Help?

What's even more interesting to those of us who care about valuation is that when you adjust for whether companies miss, meet, or beat earnings estimates, it's better to be cheap than to be a top grower. The chart to the right shows the clear linear correlation with valuation-driven outperformance, versus buying high expected growth.

This is certainly a welcomed conclusion for Callodine, where our approach to investing centers on owning high-quality stocks, generating high free cash flow yields, with positive earnings growth bought at attractive valuation multiples. So, in the end, we believe you are better off betting on the known variable of valuation than on the known variable of expected growth.

### Average Relative Return of NTM Earnings Yield

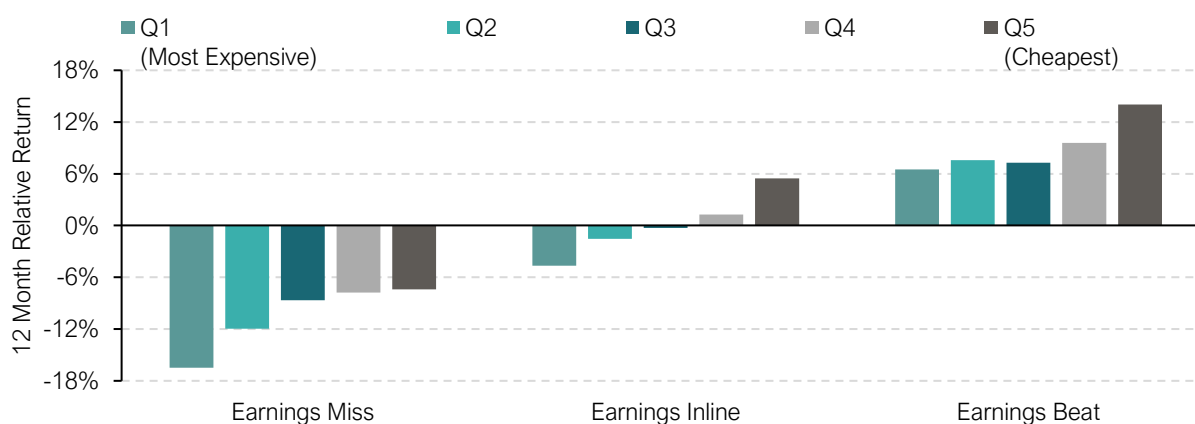
Average 12 Month Forward Relative Returns by NTM Earnings Yield Quintile<sup>1</sup>



But what if an investor is really good at predicting positive surprises? Well, good news! They should be value investors too, because finding upside surprises is rewarded more heavily among cheaper stocks than it is for more expensive ones.

## Cheaper Stocks Outperform More when they Beat and Underperform Less when they Miss

12 Month Relative Performance by NTM Earnings Yield Quintiles and Earnings Surprise<sup>1</sup>

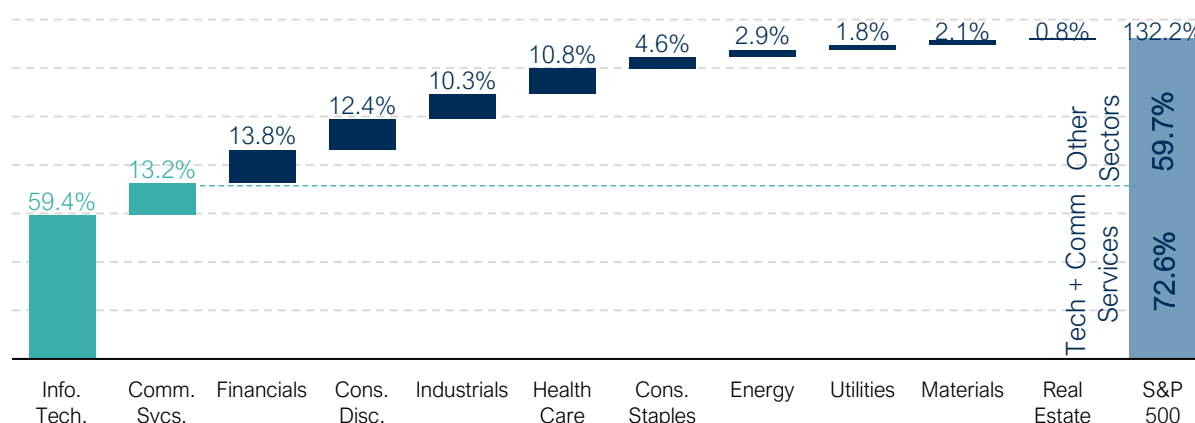


## So Where Are We Now?

It likely won't surprise most market practitioners and even casual observers to learn that nearly two-thirds of the total return generated by the S&P 500 this decade has come from two sectors; technology and communication services. The dominance of the Magnificent Seven and their closest kin has saturated financial headlines for the past few years as A.I. fever has spread across global markets.

## S&P 500 Sector Contributions to Overall Total Return

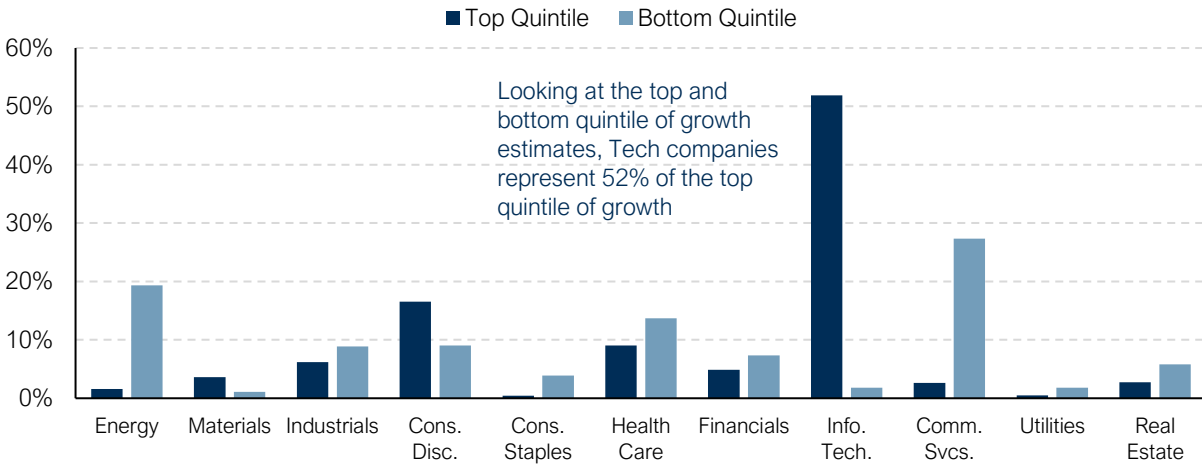
12/31/2019 - 12/31/2025



Sources: Bloomberg, Callodine Capital Research Team

Methodology: Sector contributions reflect the cumulative contribution of each S&P 500 GICS sector to total index return from 12/31/19 through 12/31/25. Monthly sector contributions are calculated of each sector's weight in the S&P 500 and its corresponding monthly total return. Sector-level contributions are aggregated over the period and summed to arrive at the S&P 500 total return. Total returns are based on gross total return indices and include reinvested dividends.

## Top and Bottom Quintile of Fwd EPS Growth: Weighting by Sector



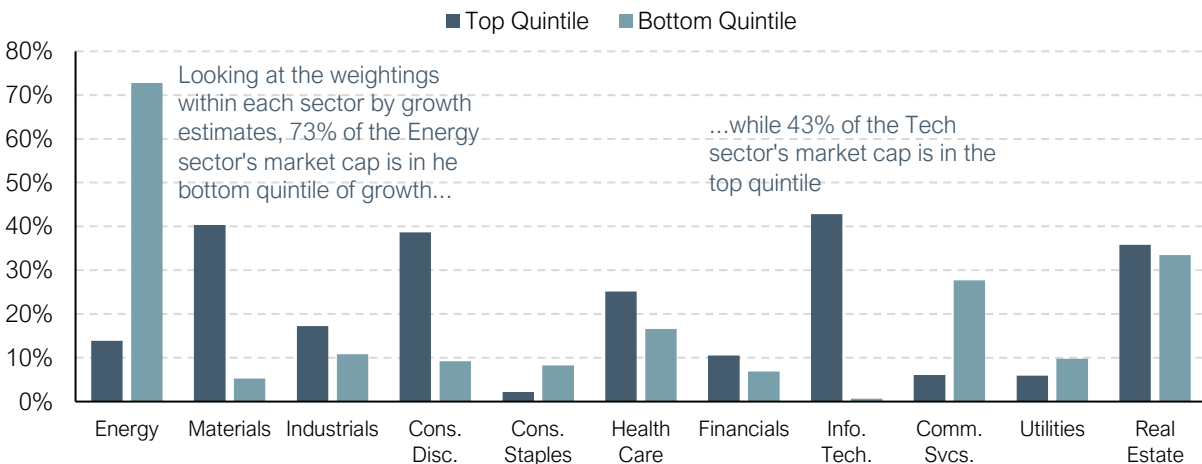
Sources: Bloomberg, Callodine Capital Research Team

Methodology: Data as of 1/26/2025. Represents data for companies in Russell 1000 with trailing 12 month EPS and forward 12 month EPS estimates. EPS growth is the calculated as  $(\text{Forward EPS est} - \text{Trailing EPS actual}) / \text{abs}(\text{Trailing EPS actual})$ . Quintiled on EPS growth, no weighting.

Rapid outperformance tends to create heightened expectations, and this is where the cycle begins. Looking at the chart above we can see that, for the top quintile of forward EPS growers, 52% of the aggregate market cap is comprised of technology stocks.

As a result, today's expectations are highest by far for those same tech stocks, where investors have crowded into the top quintile of forward earnings-per-share growers and shunned the bottom quintile. In stark contrast to technology, approximately 73% of the energy sector's market cap is in the bottom quintile of growth expectation.

## Sector Weighting: Market Cap within Sector by Fwd EPS Growth



Sources: Bloomberg, Callodine Capital Research Team

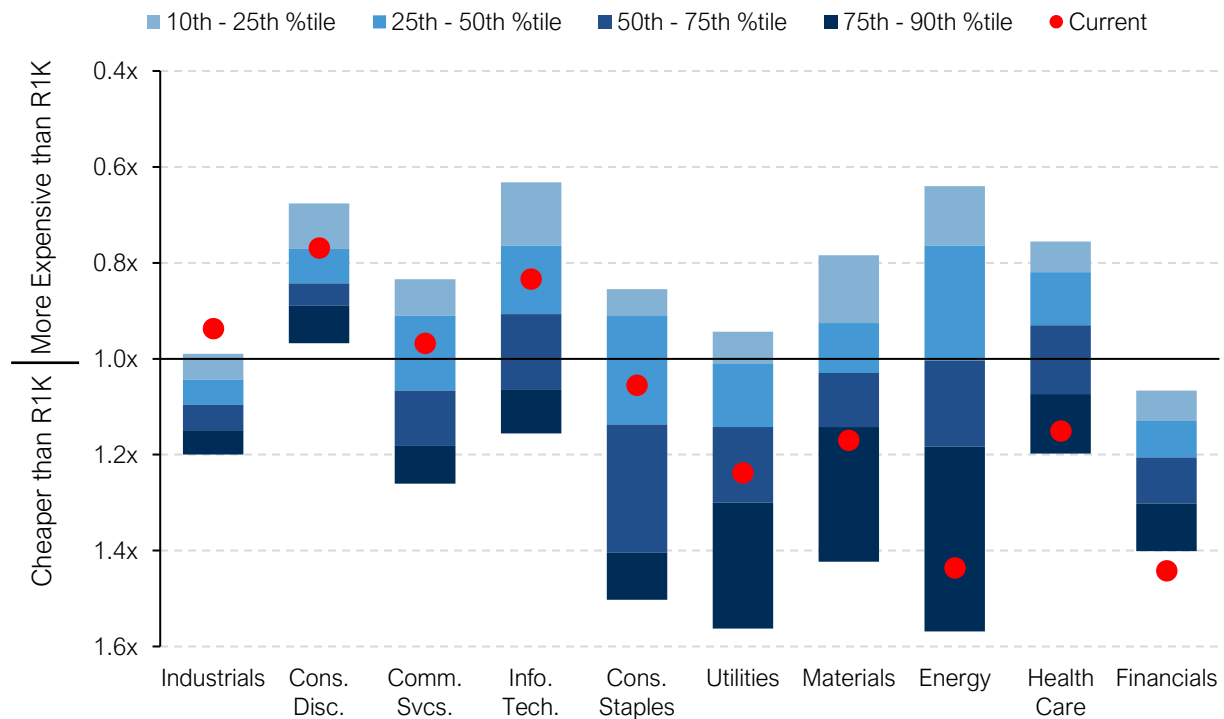
Methodology: Data as of 1/26/2025. Represents data for companies in Russell 1000 with trailing 12 month EPS and forward 12 month EPS estimates. EPS growth is the calculated as  $(\text{Forward EPS est} - \text{Trailing EPS actual}) / \text{abs}(\text{Trailing EPS actual})$ . Quintiled on EPS growth, no weighting.

Comparing expectations to valuations yields an additional insight, as valuation excess within certain areas of the market, such as industrials, has gotten even more stark than what we see in technology stocks, despite the fact that these companies are several degrees of separation removed from the A.I. wave. Industrials currently have both high expectations and extended valuations, as the only sector sitting above the 90th percentile of historical valuation ranges relative to the market, as demonstrated in the exhibit below.

Much like splitting 6’s against a dealer showing 20 at the blackjack table, our polite response would be “that might work,” but it also sets up a lot of room for error, which may seem obvious in hindsight.

### NTM Earnings Yield Relative to Russell 1000 - Current vs Historical Range

Russell 1000 Sector NTM Earnings Yield / Russell 1000 Earnings Yield  
 January 1990 through December 2025, Monthly



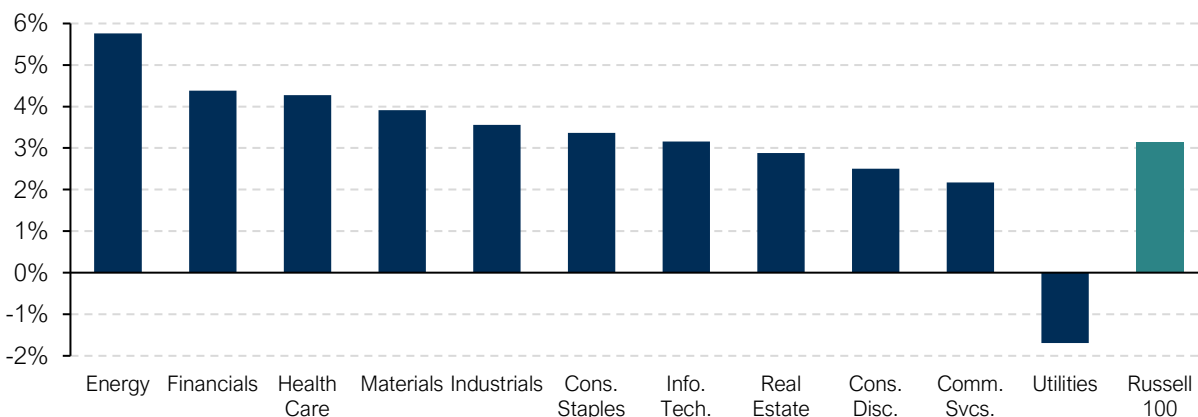
Sources: Bloomberg, Callodine Capital Research Team  
 Methodology: Market Cap Weighted NTM Earnings Yield in Sector divided by the Market Cap Weighted NTM Earnings Yield of Russell 1000 Index. Bars are historical range from 1/31/1990 through 12/31/2025. Red circle is current value as of 12/31/2025

# Focus on Free Cash Flow

Given the view that it's better to err on the side of valuation than chase high growth expectations, we choose to focus on FCF as the key value metric. As one of my original mentors used to say, "Cash is King, except in Memphis." To this end the market has taken a very divergent view on sectors right now, rewarding high levels of capital spending in technology while ignoring capital discipline within the energy sector.

## Russell 1000 - GICS Sector Forward FCF / EV

As of December 31, 2025



Sources: Bloomberg, Callodine Capital Research Team

Methodology: FCF/EV is the blended forward 12 month free cash flow estimate divided by the enterprise value as of 12/31/2025. The sector aggregate FCF/EV is the market cap weighted FCF/EV of companies in the sector with valid FCF/EV metrics.

While the graphs above show the general trends at the sector level, all of which sets the stage for a significant value-led rally, this wide divergence is even more stark at the individual security level and is creating one of the best value-driven stock picking environments we've ever seen.

From our perspective, there are two key benefits to taking this FCF-based approach:

1. It's much easier than predicting the growth trajectory of a revolutionary but nascent technology, where the range of applications and knock-on effects are not fully understood.
2. Few investors seem to be taking this approach in the current market environment.

This second point is important for investors seeking to generate sustainable alpha in what is otherwise an incredibly competitive market. At Callodine, our goal isn't to compete with every hedge fund to find the fastest growers, the sexiest "narratives" or the companies that might beat top-line expectations in a given quarter.

We'll stick to compounding capital by finding good companies with positive earnings growth at low multiples that might just surprise you. Because whether at the blackjack table or in the markets, the power of an advantaged starting point coupled with low expectations should not be underestimated.

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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 S&P 500 High Dividend Index is designed to measure the performance of 80 high yield companies within the S&P 500 and is equally weighted to best represent the performance of this group, regardless of constituent size. The Dow Jones U.S. Select Dividend Index aims to represent the U.S.'s leading stocks by dividend yield. The Russell MidCap Growth Index measures the performance of the midcap growth segment of the US equity universe and includes those Russell Midcap Index companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years). 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.

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