CALLODINE | CAPITAL

“The Lost Art of Skepticism”

Quarterly Market Commentary: Q3 2024

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Market Commentary

Imagine a market with three types of investors; Optimists, Followers and Skeptics:

- Optimists, who dream big dreams and have limited concern or fear about the unknown downside risk

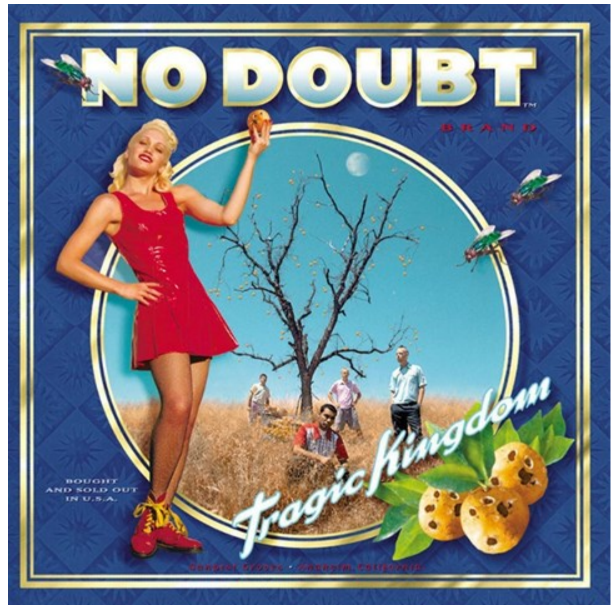
- Skeptics, who are burdened by uncertainty and consider all possible outcomes, while harboring doubts about their own omniscience

- Followers, who are unburdened from holding any views at all and simply follow the best or loudest arguments

A market comprised of just these three constituencies can stay in balance as long as there are enough optimists and skeptics to keep the market honest while it oscillates between competing views over time. Followers then ride for free.

However, if this system falls out of balance in any direction, the natural self-correcting mechanisms will break down. For example, if a market becomes dominated by followers, who are entirely dependent on the “influencers” of the day, then the core attribute required to stay in balance would become a strong diversity among the shrinking pool of active participants to prevent an unbalanced and unstable system from taking root.

A market made up primarily of followers and optimists would have a stronger likelihood of becoming a high-amplitude market trapped in self-reinforcing feedback loops until those dominant trends break, perhaps violently, in the opposite direction.



Today, we’re witnessing such a phenomenon, a “no doubt” market reaching all-time highs, driven by the widest valuation spreads in the Russell 1000 Index in more than 30 years.[1] A market where Growth investors dominate in nearly every sector and thereby set the tone for passive followers. Passive now makes up 62%[2] of investors in U.S. equity funds, who dutifully follow Growth investors in a valuation-agnostic pursuit of further gains. All news is good news, all good news is especially good for high-multiple stocks, and all dreams seemingly do come true. *Please check any skepticism at the door.*

SYSTEM CHARACTERISTICS	BALANCED SYSTEMS	UNBALANCED SYSTEMS
Feedback Loop	Negative (Corrective)	Positive (Amplifying)
Redundancy	High	Low
Adaptability	Flexible	Chaotic
Response to Agitation	Dampening	Amplifying
Suitability	High	Low

1 Source: Bloomberg, Callodine Quantitative Research. Based on monthly observations from 1/31/90 through 9/30/24, calculated on a month-end basis. Valuation spread is the average NTM P/E of Russell 1000 Index’s companies' quintiles on NTM P/E multiple, excluding securities with forward consensus P/E ratios below 3x or exceeding 40x.

2 Source: Morningstar Asset Flows as of 6/30/2024. Includes U.S. open-end and ETF, ex MM, ex FoF, ex Feeder.

The Atrophy of Efficient Markets

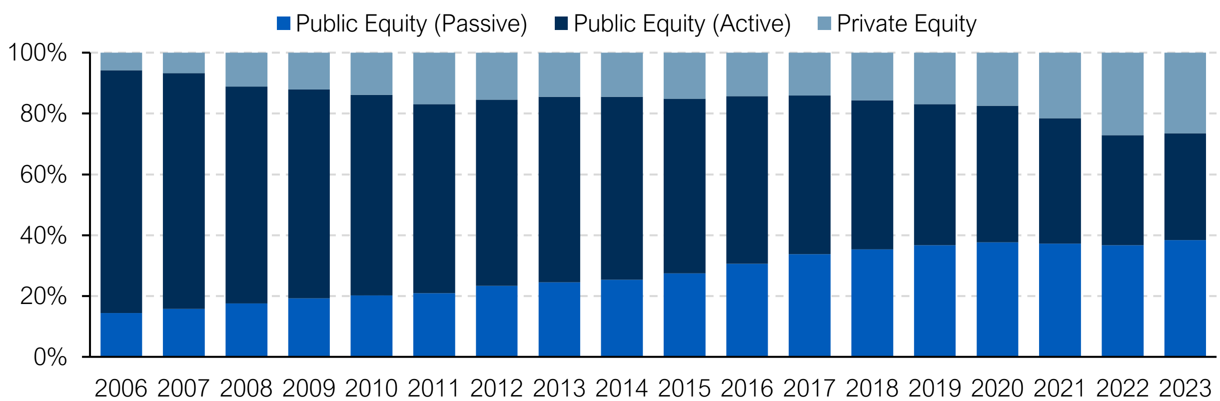
We, along with certain other Value investors (more on that later), would contend that today's market has become increasingly inefficient over time. Several readily observable signs that the market could be losing efficiency include:

Capital Flows

Over the past 15-20 years, active public equity investors have lost dramatic market share to passive strategies within public markets and to private markets via a surge in private equity and venture capital allocations.

Pension Allocation to Public (Passive & Active) and Private Equity

Allocation as a % of Equity Allocation 2006 through 2023



Sources: Pensions & Investments Research Center (as of 9/2023) via BofA US Equity & Quant Strategy, BofA Global Research. Reprinted by permission. Copyright © 2023 Bank of America Corporation ("BAC"). The use of the above in no way implies that BAC or any of its affiliates endorses the views or interpretation or the use of such information or acts as any endorsement of the use of such information. The information is provided "as is" and none of BAC or any of its affiliates warrants the accuracy or completeness of the information.

To compound this issue, Value investors have been further losing market share within the shrinking active equity pool. Looking at the table below published recently by Bank of America, we can see that Value strategies make up less than 25% of long-only equity funds today.

US LARGE CAP LONG-ONLY EQUITY FUND CHARACTERISTICS BY STYLE

	Core		Growth		Value		TOTAL
		% of Total		% of Total		% of Total	
Total Assets in Funds ($m)	977,927	31.4%	1,396,355	44.9%	738,337	23.7%	3,112,619
Number of Funds	136	37.4%	158	43.4%	70	19.2%	364
Avg # of Stocks	99		75		78		85

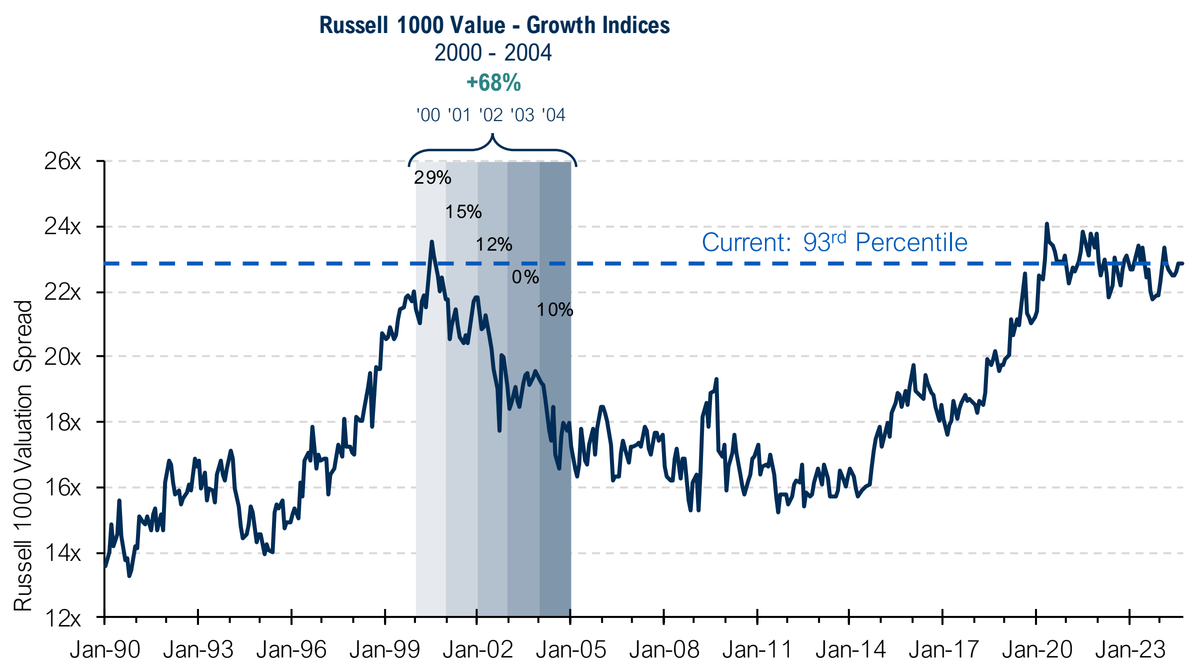
Sources: BofA Global Research. BofA US Equity & Quant Strategy Active Managers' Holdings Update published on September 30, 2024. Figures based on a sample of funds from Lipper, and holdings are pulled from FactSet. Reprinted by permission. Copyright © 2023 Bank of America Corporation ("BAC"). The use of the above in no way implies that BAC or any of its affiliates endorses the views or interpretation or the use of such information or acts as any endorsement of the use of such information. The information is provided "as is" and none of BAC or any of its affiliates warrants the accuracy or completeness of the information.

Style Dominance

The U.S. equity market tends to be in either a divergent or a convergent mode across a given market cycle. Convergent markets, where the valuation spread between expensive and cheap stocks narrows, typically favor Value investing.

Valuation Spread in the Russell 1000

Jan 1990 through Sep 2024 (Monthly Obs)



Sources: Callodine Quantitative Research. Bloomberg

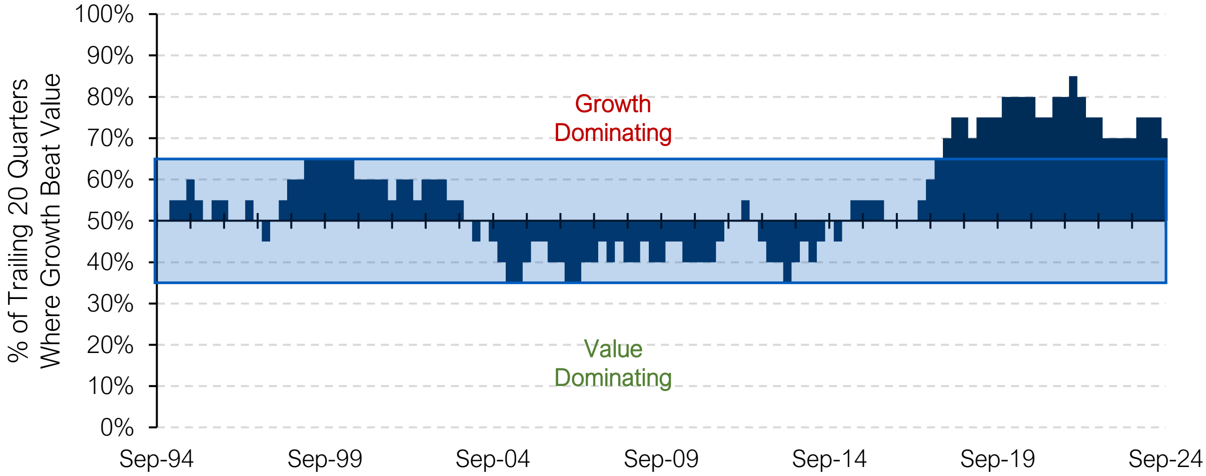
Methodology: Valuation spread is the average NTM P/E of Russell 1000 companies quintiles on NTM P/E multiple, excluding securities with forward consensus P/E ratios below 3x or exceeding 40x. Calculated on a month end basis from January 1990 through June 2024. Shaded areas represent the total return difference between the Russell 1000 Value Index and the Russell 1000 Growth index during the calendar year.

Although these are normal market cycles, it's been a while since Value investors have enjoyed a run. The chart on the next page highlights the trailing 5-year winning percentage by style across the past 40 years. Prior to 2018, no style dominated the prior five years to a degree where it had prevailed more than 65% of the prior 20 quarters. The prior 110 quarterly readings were split 50.5% in favor of Value and 49.5% for Growth.

Since the start of 2018, pure dominance by Growth has resulted in an unprecedented win rate of 73% of all quarters since the current period started in mid-2013.

Trailing 5 Year Style Winning % (Growth vs Value)

Sep 1994 through Sep 2024 (Quarterly)



Sources: Bloomberg, Callodine Capital Research Team

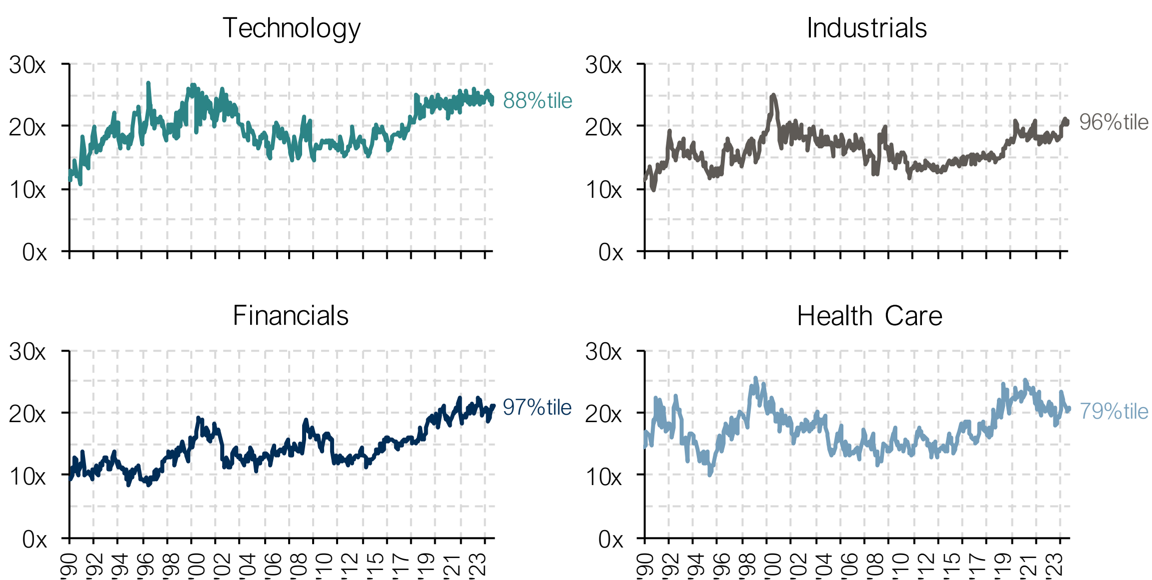
Methodology: Percentage of Quarters in Trailing 20 Quarters where Russell 1000 Growth Index outperformed Russell 1000 Value Index.

Loss of Value Instincts

While this may be considered a Value vs. Growth dynamic, the fact that Value investors are slowly disappearing from the market has caused this valuation-agnostic approach to take root in all sectors, including those traditionally thought of as Value sectors.

Valuation Spreads by Selected Sectors in Russell 1000

Jan 1990 through Sep 2024 (Monthly)



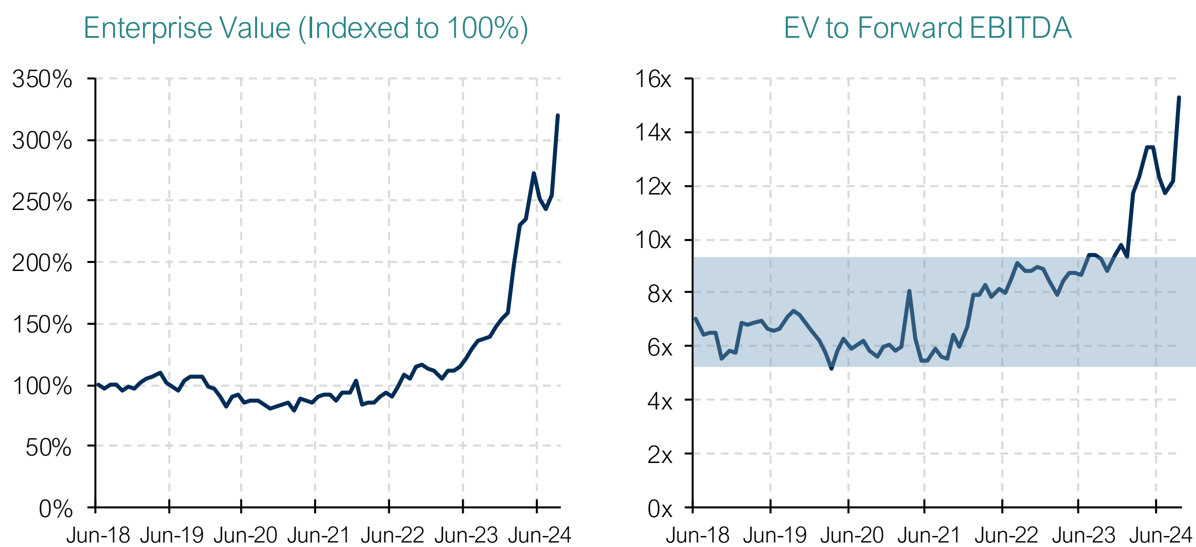
Source: Callodine Quantitative Research, Bloomberg.

Note: Monthly Obs. 1/31/90 through 9/30/24, calculated on a month-end basis. Valuation spread is the average NTM P/E of Russell 1000 companies quintiles on NTM P/E multiple, excluding securities with forward consensus P/E ratios below 3x or exceeding 40x. Grouping is based on Bloomberg Industry Classification (BIC).

Increasingly, we are seeing two worlds within public markets. One is “the singularity,” a cadre of stocks owned by Growth investors and seemingly everyone else, where valuation is an optional consideration. The other is made up of those stocks left out in the cold, where valuation still matters. We have occasionally seen Growth investors wander into this downtrodden Value universe and pluck a name out when it achieves “story stock” status. For example, witness the miraculous transformation of the independent power producers (IPPs) within the utilities landscape this year, which were consistently trading at 5.5x to 9.0x enterprise value/EBITDA, but have since doubled in enterprise value and vaulted to a nearly 16.0x multiple in the blink of an eye.

Independent Power Producers Enterprise Value and EV to Forward EBITDA

Jun 2018 through Sep 2024 (Monthly)



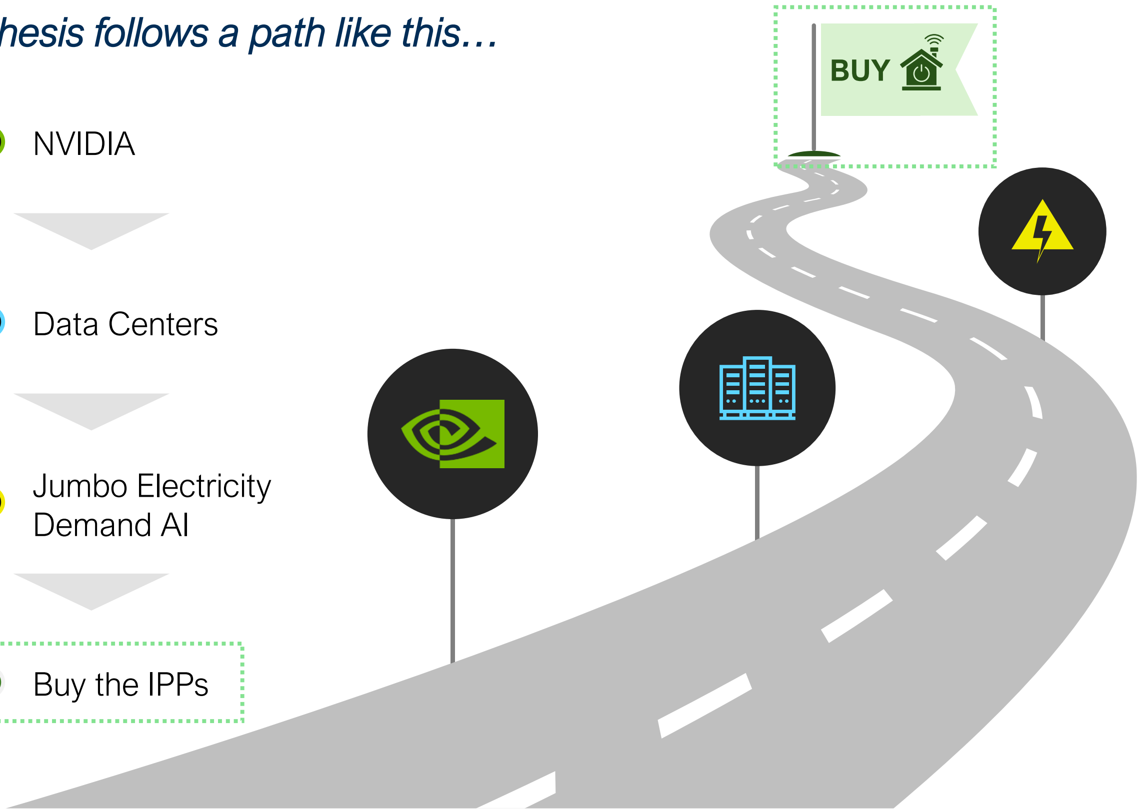
Sources: Bloomberg, Callodine Capital Research Team

Methodology: IPP Index is market cap weighted composite of Vistra Corp (VST), Constellation Energy Corp (CEG), and Talen Energy Corp (TLN). Index divisor is adjusted monthly to reflect changes in shares and index additions/deletions. Enterprise Value is indexed to 100% of value on 6/30/2018. EV to Forward EBITDA is the ratio of current enterprise value to the next 12 month estimate of EBITDA.

The driver of the IPP’s rise is artificial intelligence, and IPPs have become investors’ third-derivative way to “play” AI.

The thesis follows a path like this…

- NVIDIA
- Data Centers
- Jumbo Electricity Demand AI
- Buy the IPPs



It seems that very little thought is being applied to:

- What investors are paying for this collection of generation assets
- The industry’s long history of volatility and bankruptcies
- The realities of pulling existing baseload capacity from the grid
- The Federal Electricity Regulatory Commission (FERC)
- Potential power/cooling efficiency offsets
- The potential to build new capacity that more than offsets potential power demand

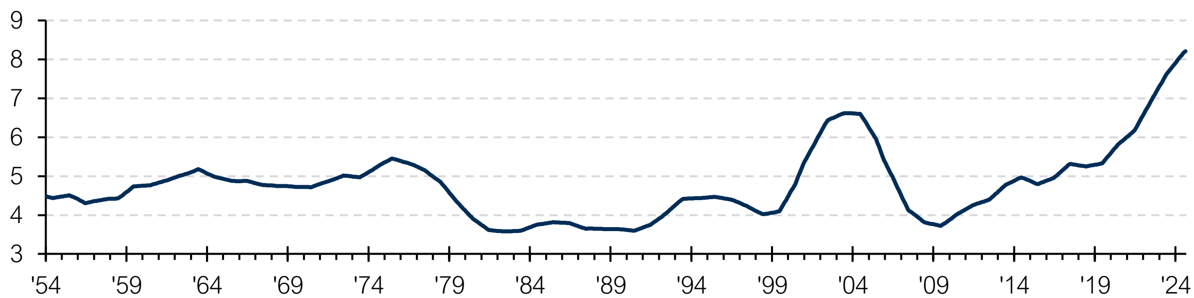
None of these considerations enter the conversation when the narrative around these stocks is dominated by, “How big can this total addressable market be?”

The End of Value, or the Largest Opportunity in the Market?

These conditions have led one of the best-known Value investors to question his faith. Cliff Asness, Managing Principal of AQR, recently wrote a treatise titled, “The Less-Efficient Market Hypothesis,” which addressed whether markets have gotten more or less efficient over time, given the disappearance of value as a driver of stock returns. As evidence, Asness points to the persistently wide value spread in the market (see the chart below), which looks remarkably similar and highly correlated to the aforementioned Growth over Value style dominance.

Fama-French Value Spread 5 Year Average

Jan 1954 through Aug 2024 (Monthly)

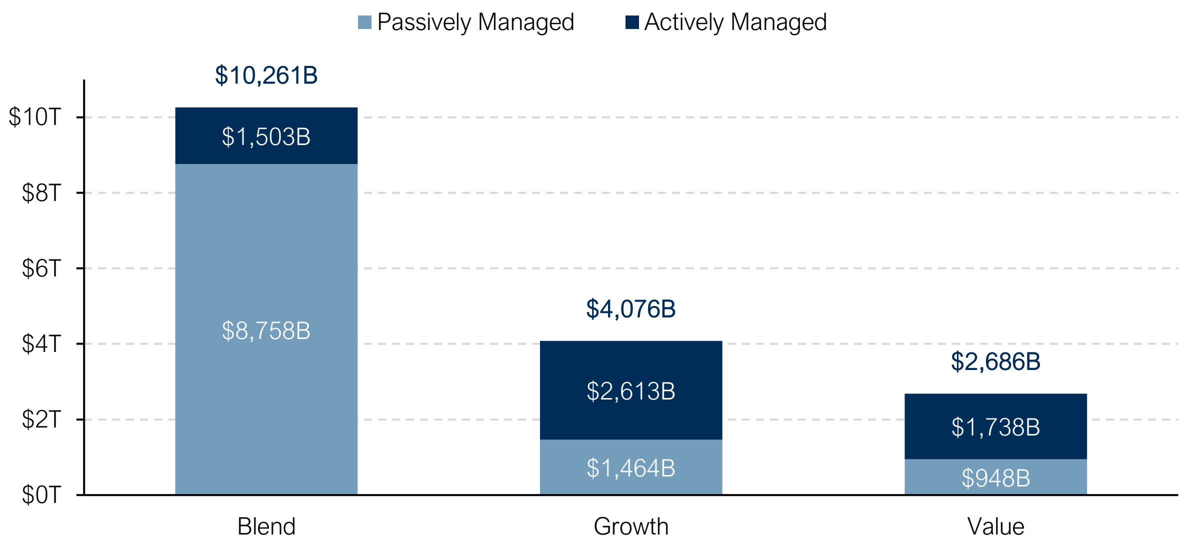


Sources: Ken French via https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, AQR, Callodine Capital Research Team.
Methodology: Ratio of Book Yield of "BIG HiBM" (Large Cap High Book Yield) to Book Yield of "BIG LoBM" (Large Cap Low Book Yield) cohorts.

Contrarians, take note: we are in uncharted waters in terms of the duration, magnitude and persistence of Growth over Value investing.

We agree with Asness’s conclusion that today’s U.S. equity market is less efficient for many reasons, including indexing, an extended period of lower interest rates, and the impact of technology. To his list, we would add market myopia and investors’ inability to take a longer-term view of the market’s historical patterns, as well as a herd mentality that we have not witnessed since the tech bubble, if ever.

AUM of Largest US Equity Funds by Strategy and Management Type
As of Sep 30, 2024



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Asset Under Management (AUM) of Top 1000 ETFs and Open-End Funds with a Fund Geographic Focus of "U.S." and Fund Asset Class Focus of "Equity".

Where Have All the Value Investors Gone?

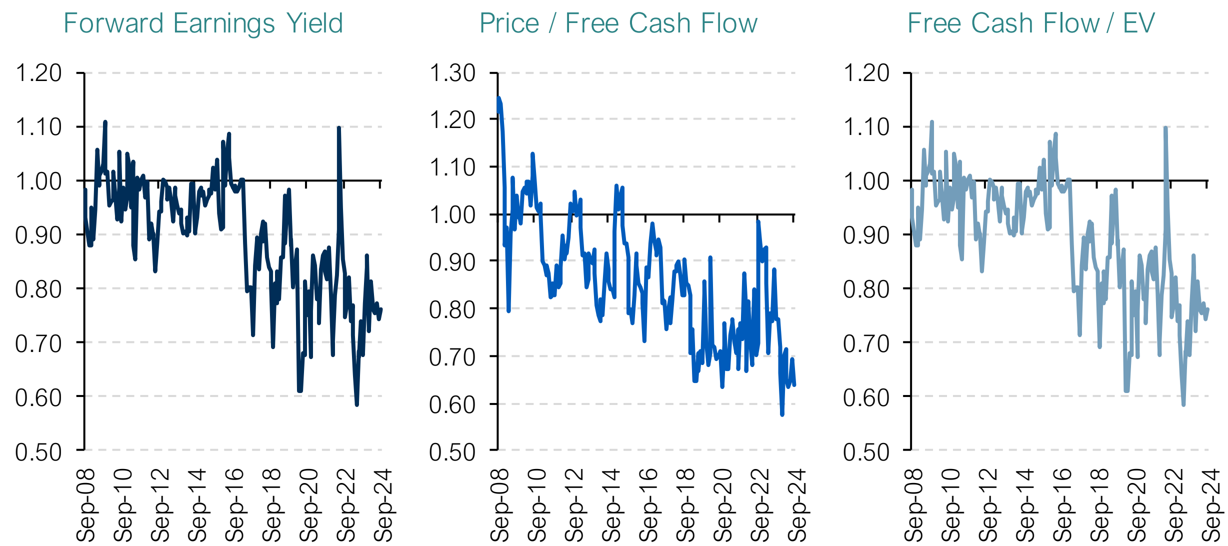
We are often asked who might be the marginal buyer of Value names that have long been forgotten by momentum investors and trend followers—or, if there is no marginal buyer, can Value ever outperform again? Our response is an unequivocal “yes.”

Value investing has not worked as a style over the last decade and a half, but the opportunity has increased, given that there are far fewer participants and the market continues to ignore both divided and free cash-flow yield as meaningful allocations within a portfolio. As we can see in the exhibit below, investors have gotten increasingly long Growth and underweight Dividend Yield investing compared to the S&P 500. This shouldn’t come as a surprise, but it does mean that there are fewer institutional participants fishing in the Value pond.

This environment has led to the de-emphasis of considering value metrics in investment decision-making in public markets. If we look at the long-only relative weighting of value factors (earnings yield, free cash-flow yield and price / free cash flow), we can see that funds are increasingly underweight these metrics. We believe this creates a scenario where certain stocks, favorable by these metrics yet under-owned and overlooked by most institutional investors, are becoming increasingly undervalued relative to the broader market.

Long-Only Funds' Relative Weight (vs. S&P 500) in Value Factors

Sep 2008 through Aug 2024 (Monthly)



Sources: BofA US Equity & Quant Strategy, FactSet Ownership

These conditions present a Value investor's dream scenario: Stocks that demonstrate attractively priced free cash-flow yields are readily available in the market, and the market is increasingly less discerning within the Value factor, meaning that, somehow, the price-setting mechanism for Value stocks has become less efficient. We believe this scenario creates an amazingly rich alpha-generation opportunity for Value investors willing to roll up their sleeves and do the fundamental work required to understand how these cash flows are being priced in the public market.

To the latter point, valuation spreads today are as wide as we've seen in over three decades.[3] The practical implication is that today's investors most likely have to be older than 50 to have seen the last Value cycle. I'm old enough to have seen this happen once before, when valuation faded as part of the conversation and analysts and portfolio managers became much more focused on the narrative behind a stock or sector. This investment strategy can be incredibly effective in the short term. However, over long periods of time, it's an extremely dangerous way to allocate capital and compound returns.

The trend from active to passive has prolonged this cycle, as we wrote about extensively in our last quarterly letter, "Passive Aggressive." Passive flows don't care about valuation, and they definitely don't "buy the dip." From our perspective, this creates a dynamic where the reversal could be quite stark.

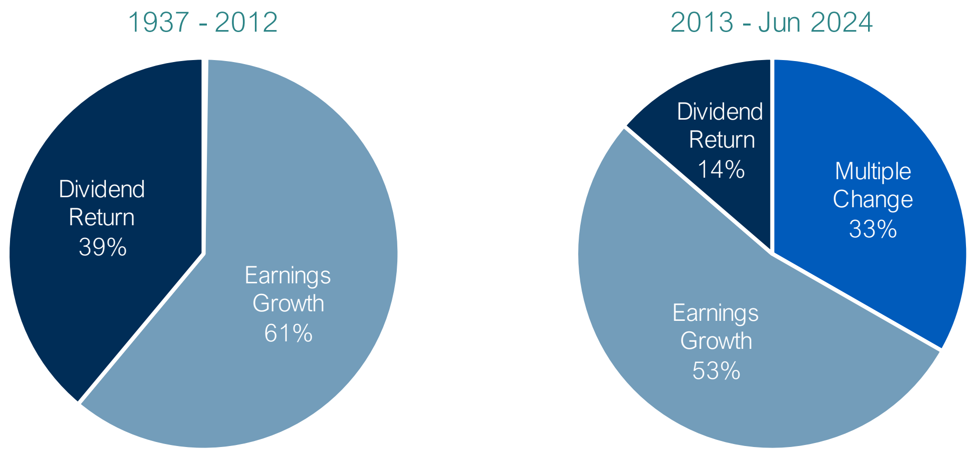
3 Source: Bloomberg, Callodine Quantitative Research. Based on monthly observations from 1/31/90 through 9/30/24, calculated on a month-end basis. Valuation spread is the average NTM P/E of Russell 1000 Index's companies' quintiles on NTM P/E multiple, excluding securities with forward consensus P/E ratios below 3x or exceeding 40x.

The Forward Opportunity

If the market ever migrates away from mega-cap tech—and history suggests that it will—investors will have to identify a new narrative to take up the mantle of momentum. Maybe it's the energy sector, due to the combination of AI power demands and conflict in the Middle East. When one narrative breaks, the market will find another theme to ride. Perhaps that theme will be the return of dividends as a driver of equity returns. Multiple expansion can't work forever, after all.

S&P Composite Total Return Decomposition

Jan 1937 through Dec 2012 vs Jan 2013 through Jun 2024



Sources: Robert J. Shiller via https://shillerdata.com/, Callodine Capital Research Team

Methodology: Percent Contribution to Total Return of S&P Composite from Dividend Return, Trailing Earnings Growth, and Change in Trailing P/E Ratio.

Relative NTM EY of Top Quintile Dividend Yield vs S&P 500

Sep 2004 through Sep 2024 (Monthly)

Sources: Bloomberg, Callodine Capital Research Team

Methodology: Earnings Weighted NTM P/E of Top Quintile Indicated Dividend Yield S&P 500 Constituents divided by the Earnings Weighted NTM P/E of the S&P 500.

When the market eventually pivots away from Growth sectors that trade off revenue multiples and TAM, there are not many raft guides to help navigate a Value market. The cash-flow and balance sheet analysis that is critical to evaluating businesses from the traditional economy is a lost art within the current investment community.

The analogy we like to use (in jest) is that Callodine is like the Bubba Gump Shrimp of Value investing—we have weathered the storm of an insatiable and persistent Growth rally, and we feel we are positioned for a haul, should the market ever reverse course.

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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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