RECURRENT
INVESTMENT ADVISORS

Monthly Investment Commentary
July 2023

Midstream: last month, our new white paper laid out how 1) even in a higher-rate environment, midstream dividend and earnings yields remain historically cheap vs. fixed income; and 2) lack of recent dividend growth has obscured strong midstream earnings growth. This month, we compare midstream with two yield-oriented equity asset classes – Utilities and REITs – and find the comparison even more striking. Despite record high debt leverage for utilities and WFH challenges facing office building REITs, both utilities and REITs retain significant valuation premiums compared to midstream. This is despite superior earnings growth for Midstream and debt reduction in the last 5 years. Compared to midstream, Utes especially standout for their ballooning debt, relatively low earnings yield, and free cash flow negativity. We dig in more below.
Click here for our new midstream white paper, which explores midstream's near-record excess earnings yields vs. fixed income.

Natural Resources: In the world of portfolio management, one of the most tried and true metrics used to assess volatility and predict likely future performance is correlation. Correlations between financial securities offer investors a sense for historical relationships, which are commonly extrapolated to the future. In the context of global natural resources, the global paper sector provides a unique case study in the most recent ten-year period. Comprising nearly 10% of the global natural resources benchmark, the paper sector plays a significant role to determine natural resources' performance. While prior to 2020, paper was viewed as a less volatile "diversifier" for natural resources investors, since 2020, high valuations and slowing e-commerce trends have caused paper to underperform – but correlations to broader commodities have actually increased!

Click here for the latest white paper on the long-term relationship between inflation and capex
Click here for our 2022 white paper on Shale's increased strategic importance in a time of ESG
(noteworthy in light of CVX-PDC deal)

July 2023 Performance Summary and Market Commentaries
Please find below performance and commentary for our strategies – MLP & Infrastructure and Natural Resources. Performance follows at the bottom of the commentary. For additional information, please contact us at (832) 241-6400 or info@recurrentadvisors.com.

MLP & Infrastructure

Performance review

During the month of July 2023, the Recurrent MLP & Infrastructure Strategy generated net returns of +6.82%, outpacing the Alerian MLP Index's (AMZ) +5.96% return by +0.87%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +3.12% (annualized, net of fees). Please see the performance section at bottom for more detail.

Last month, we noted Midstream's "yield spreads" vs. fixed income remain historically wide

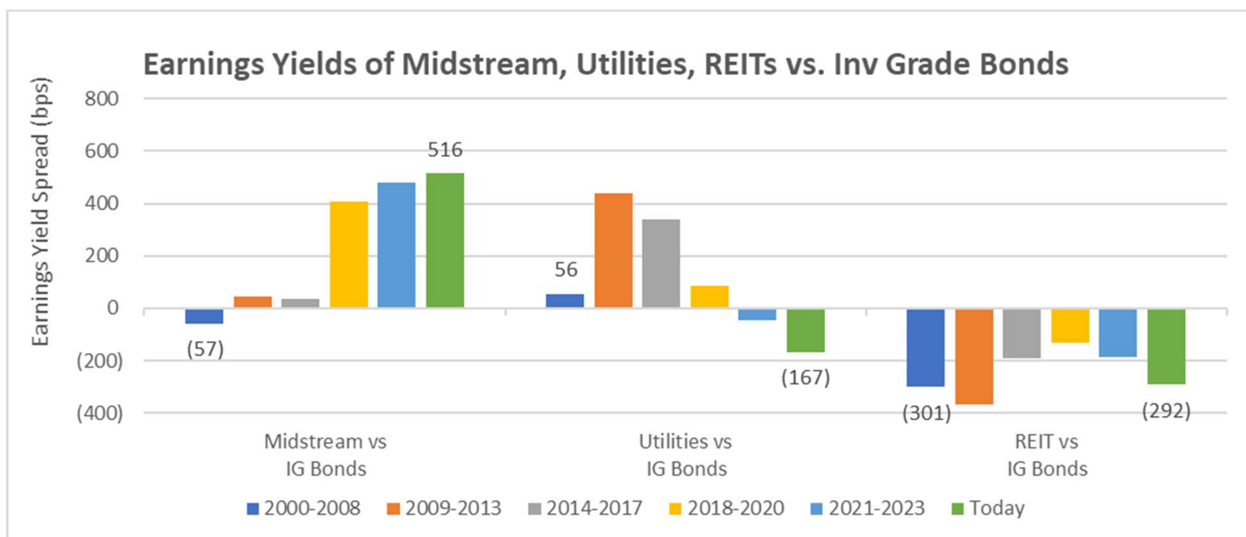
We've extensively documented the improvement in the Midstream sector's credit profile, and shown how a steep decline in capex has driven a free cash flow (FCF) profile that is competitive with any sector in the capital markets. As a result of these fundamental improvements, midstream dividend yields have tightened meaningfully, sitting 127 bps above investment grade bond (IG) yields, although they remain meaningfully wider than historical spreads.

What dividend yield metrics miss is the fact that midstream earnings have grown much faster than dividends for the last 5 years. As a result, midstream dividend payout ratios are near historic lows, and midstream earnings yields are now at record levels vs. fixed income yields. As shown below, midstream earnings yields offer +516 bps vs. IG bonds. In other words, while midstream earnings yields have historically approximated IG yields, today midstream earnings offer roughly 5% more yield than IG bonds. Although we are not predicting performance, we would note that a return to long-term historical averages would cut midstream earnings yields in half – implying ~100% upside to midstream valuations!

Timeframe	2000-2008	2009-13	2014-17	2017-20	2021-23	Today
Leverage Ratio	3.5x - 4.5x	4.0x-5.0x	5.0x-6.0x	4.5x-5.5x	4.0x-4.5x	<4.0x
Debt Trajectory	Flat	Slow rise	Steep rise	Slow fall	Rapid fall	Falling
Capex / CFFO	142%	173%	183%	88%	49%	47%
Midstream Div Yield	5.3%	5.2%	5.3%	7.0%	6.4%	6.6%
Div Yld Spread vs. IG Bonds	-86	+8	+146	+348	+265	+127
Dividend/Net Income	95%	94%	127%	96%	75%	63%
Midstream Earnings Yield	5.5%	5.6%	4.2%	7.3%	8.5%	10.5%
Earnings Yield vs. IG Bonds	-57	+43	+35	+375	+475	+516

Midstream may offer excess yield vs. fixed income… but perhaps REIT and Utility markets are similarly discounted?

We've asked ourselves whether the "Midstream Discount" is real, or if it is a result of a broad investor preference for bonds over high-yield "real asset" equities? If investors are broadly avoiding asset-intensive, high-payout equities, then we should see REITs and Utilities suffering from the same valuation discounts as Midstream.



Source: Recurrent research, Bloomberg, SEC filings

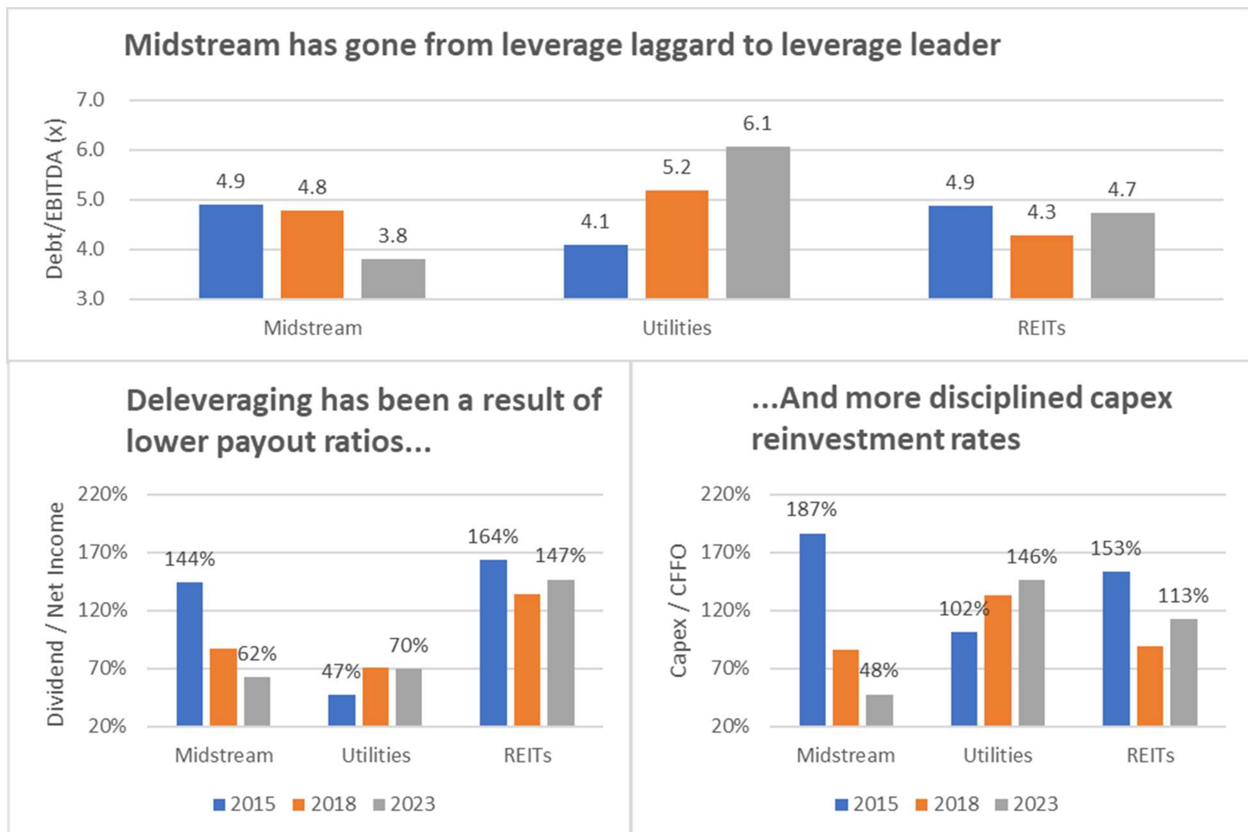
As we see above, investors are **NOT** avoiding Utilities and REITs. Looking at the chart above, Midstream yields have risen >500 bps vs. IG bonds. Meanwhile, Utilities are more expensive today than any time in the past 23+ years. Meanwhile, REITs offer 300 bps less in earnings yield vs. IG bonds, roughly in-line with history. We are forced to conclude that the “Midstream Discount” is not a broad aversion for income generating real assets.

Midstream has been put in the “discount” bin, while utilities and REITs have seen valuation premiums… but on what basis?

Incredibly, in a world where office buildings are sitting partially occupied or unoccupied in many coastal US cities and vacant malls are being repurposed, investor appetite for real estate investments remains strong.

Utilities are a more nuanced case. Defenders of Utilities would argue that, as the key constructors and operators of solar/wind power generation assets, Utilities have a long-term role to play in the “Energy Transition.” While we would argue that Midstream has a role to play as well (carbon capture, hydrogen and biofuels infrastructure, natural gas backup for intermittent renewables), we would also note that the Midstream industry played a leading role in the very real Shale revolution, and investors were left with little profitability to show for it from 2010-2020.

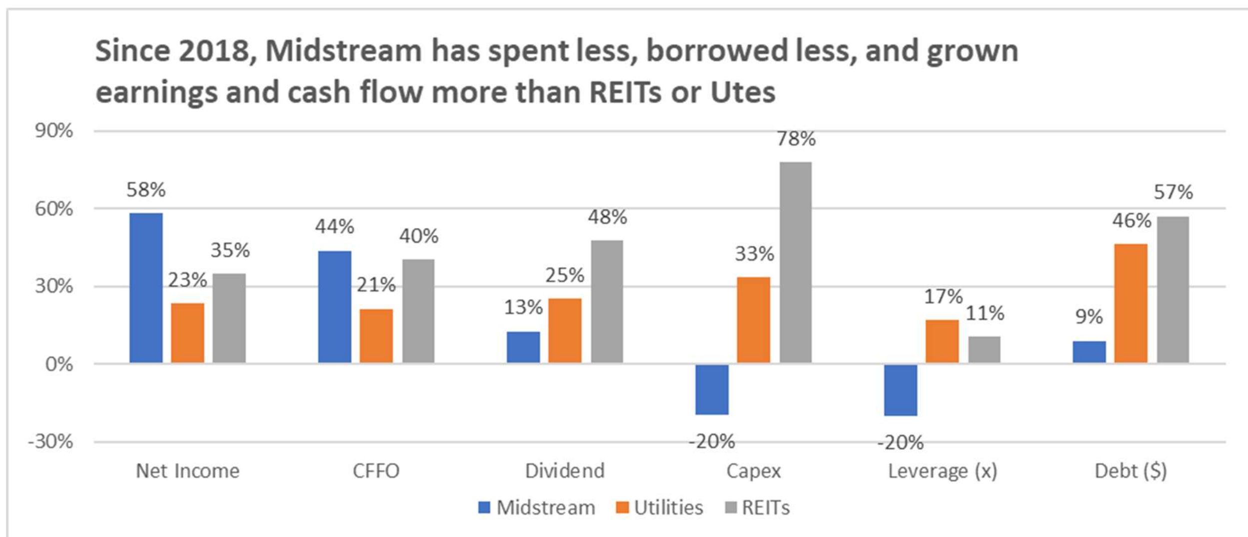
More enlightening than a qualitative discussion is an examination of fundamentals. Below, we evaluate the financial health of these three “real asset” sectors on a variety of metrics. While the financial metrics look lopsided, they are not lopsided in favor of Utilities and REITs, the sectors trading at premium valuations vs. bonds (and history).



Source: Recurrent research, Bloomberg, SEC filings

Could Midstream's conservatism hide growing "stranded asset risk?"

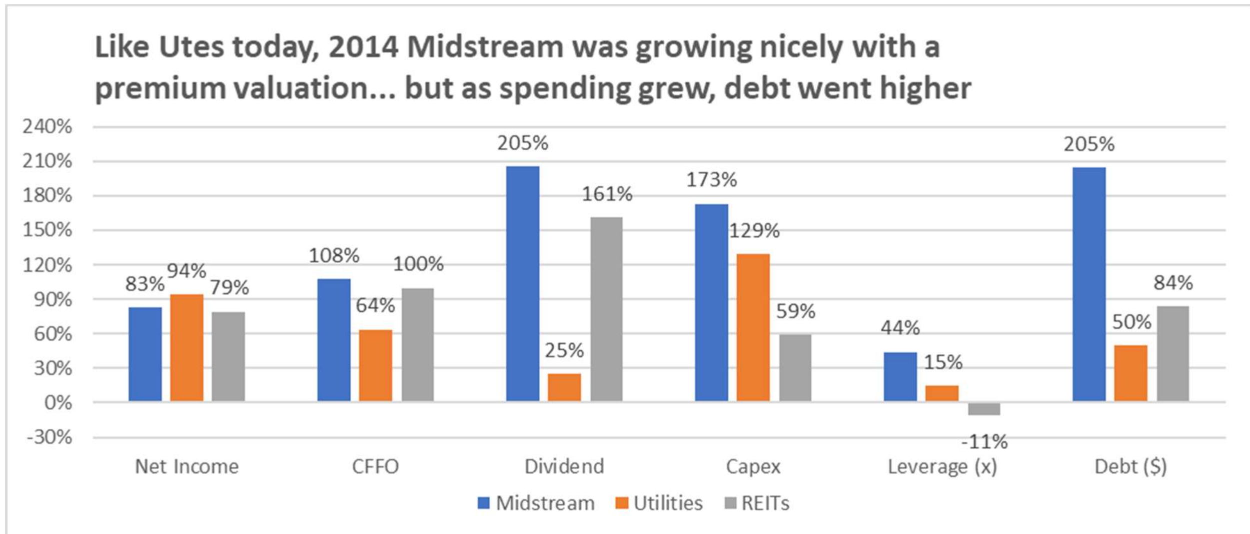
We often hear that the "hidden variable" that explains the Midstream discount is Midstream's "stranded asset risk" or "obsolescence risk" associated with the risks of the Energy Transition. But shouldn't an "obsolescent" industry be shrinking? Below, we see that far from shrinking, Midstream cash flow and earnings growth has actually outpaced Utilities and REIT growth since 2018 – but not for those other sectors' lack of trying. Utilities and REITs have built more, acquired more, and **borrowed** more to keep growth going.



Source: Recurrent research, Bloomberg, SEC filings

A historical case study: on these metrics, what would Midstream have looked like in 2014?

A final, potentially cautionary, note: it's reasonable to assess the situation and say that Midstream is now a conservatively-managed industry. That conservatism arose from a troubled past and issues with excessive debt. But at the time that trouble was brewing, Midstream looked much like Utilities today. A rock-solid growth narrative ("capex required for Shale" was then, "capex required for the Energy Transition" is today); earnings and cash flow growth; and ample and growing dividends. But as shown below, from 2009-2014, there were signs. Just like Utilities and REITs are grappling with a post-COVID business model today, Midstream was in the midst of a debt-funded pivot (from boring "toll roads" to growing Shale infrastructure), and capex and dividends were growing much faster than underlying cash flow – just like Utilities and REITs today.



Source: Recurrent research, Bloomberg, SEC filings

Natural Resources

Performance Review

In the month of June 2023, the Alma Recurrent Global Natural Resources Strategy generated returns of +9.03% net of fees, +1.34% ahead of the S&P Global Natural Resources Index's +7.69% return. Since the its June 2018 inception, the Recurrent Global Natural Resources Strategy has outperformed its benchmark by +2.98% (annualized, net of fees). Please see the performance section at bottom for more detail.

Investment Discussion

In the 10-year period starting in July 2013, the paper sector has performed strongly compared to the global natural resources benchmark, as seen below:

Sources: Bloomberg, Recurrent research

During that 10-year period, the paper sub-sectors displayed moderate (0.61-0.65) correlation to the broader global natural resources index. The combination of strong outperformance with relatively high correlations to the global natural resources index suggested that future paper sector performance would approximate the broader natural resources, potentially with stronger performance and lower volatility compared to more traditional “commodity” or “resources” sectors.

07/31/2013 - 07/31/2023 | Weekly | Calculation: Correlation | Local CCY

Correlation Matrix (3 Rows x 3 Columns)

Security	S12PAP	S12PAF	SPGNRU
11) S12PAP	1.000	0.749	0.650
12) S12PAF	0.749	1.000	0.610
13) SPGNRU	0.650	0.610	1.000

Sources: Bloomberg, Recurrent research

While the strong performance and correlations of the paper sector may be used as insights into the future, breaking the ten-year period into shorter periods offers very different perspectives.

5-years pre-2018

In the period prior to and including July 2018, the paper sectors performed well on a relative basis, with correlations below 50%. This performance added to investor perceptions that paper was a “diversifier” in the natural resources category.

Source: Recurrent research, Bloomberg, SEC filings

07/31/2013 - 07/31/2018 | Weekly | Calculation: Correlation | Local CCY

Correlation Matrix (3 Rows x 3 Columns)

Security	S12PAP	S12PAF	SPGNRU
11) S12PAP	1.000	0.769	0.453
12) S12PAF	0.769	1.000	0.485
13) SPGNRU	0.453	0.485	1.000

< 50%

Sources: Bloomberg, Recurrent research

5 years post-2018

The pre-2018 combination of the Paper sector and Global Natural Resources Index returns, along with the <50% correlation between the returns, makes the post-2018 even more noteworthy. In comparison

to the pre-2018 period, the correlation between the Paper and Global Natural Resources return streams rose significantly, to >70%. The implication is that the returns would act more in line with one another, most likely with stronger relationships than the pre-2018 period.

07/31/2018 - 07/31/2023 | Weekly | Calculation: Correlation | Local CCY

Correlation Matrix (3 Rows x 3 Columns)

Security	S12PAP	S12PAF	SPGNRU
11) S12PAP	1.000	0.738	0.761
12) S12PAF	0.738	1.000	0.708
13) SPGNRU	0.761	0.708	1.000

>70%

Sources: Bloomberg, Recurrent research

Although the correlation between the paper sector and broader index is higher, the variance between actual returns is quite wide. Importantly, the absolute performance of the paper sectors is approximately flat, while the global natural resources index is comfortably positive. With a materially higher correlation, a natural expectation would be for the paper to have a tighter relationship with the index, not increased discrepancies.

Security	Currency	Price Change	Total Return	Difference	Annual Eq
1) S12PAPA Index	USD	-7.15%	9.56%	14.81%	1.84%
2) S12PAFO Index	USD	-19.82%	-5.25%	--	-1.07%
3) SPGNRUN Index	USD	38.10%	38.10%	43.35%	6.66%

Sources: Bloomberg, Recurrent research

Since 2021

Lastly, the period from July 2021 to the present offers the most stark differences compared to the pre-2018 period. On the surface, the correlation between paper and global natural resources performance remains relatively high, above 50%.

07/31/2021 - 07/31/2023 | Weekly | Calculation: Correlation | Local CCY

Correlation Matrix (3 Rows x 3 Columns)

Security	S12PAP	S12PAF	SPGNRU
11) S12PAP	1.000	0.668	0.632
12) S12PAF	0.668	1.000	0.552
13) SPGNRU	0.632	0.552	1.000

Sources: Bloomberg, Recurrent research

However, the return profile could not be more different, and seemingly uncorrelated!   The paper sectors fell significantly, while the benchmark has risen more than 9% on an annualized basis. The correlation between the two sectors appears strong, but the sharp fall in the paper sector counters that perspective.

Sources: Bloomberg, Recurrent research

While correlations between the paper sector and the global natural resources index remained relatively high over the entirety of the ten year period, one additional factor which influences the interplay of returns and correlations is valuation. A simple valuation methodology which looks at how the market values a company's assets is Price/Book, as seen in the chart below. On that basis, the sector reached highs in 2018, and a lower peak in 2021. From those relatively expensive levels, the sector significantly underperformed, even as the correlation to the global natural resources index remained strong.

Sources: Bloomberg, Recurrent research

As one of the most fundamental calculations in investing, correlation is generally used to use historical relationships as a tool to provide future insights. However, the combination of returns and correlations of the paper sector to the global natural resources index over the last ten years have provided very different perspectives. From periods of strong performance with strong correlations to poor relative performance with even stronger correlations, historical analysis of the paper sector varied tremendously as determined by the chosen time period.

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