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#27

THE BIG SECRET ON WALL STREET

Why Artificial Intelligence Investors Are Heading For A “Die-Up”

- Lessons From America’s First Great Economic Boom and Bust
- The Real Story of the American West Isn’t Paramount’s “1883”, It’s What Happened in 1887
- Plus, One of the Very Best Businesses in the World is Now a Buy

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By the early 1880s, Cheyenne, Wyoming was the wealthiest city *in the world*.

Flush with a never-ending stream of cash from their enormous ranches, the "Cattle Kings" established the Cheyenne Club in 1880. Designed to rival Denver's Corkscrew Club, it was built to surpass the luxuries offered in London's finest social clubs.

It had an indoor tennis court, served champagne at every meal, and offered the finest food from around the world – even fresh oysters.

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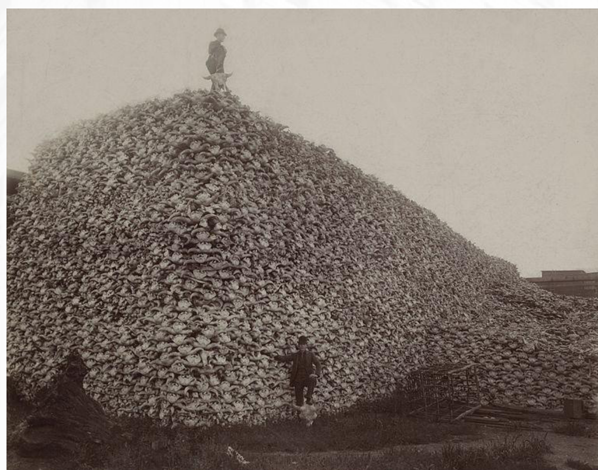
The first "Cattle King" was John Wesley Iliff, a grocer who assembled a herd outside of Denver in 1861. His clients were local – he sold beef to the crews building the first western railroads and to the soldiers manning the Army's forts built to protect them.

Demand for beef grew rapidly, especially after the Civil War ended in 1865. And Iliff made so much money supplying beef for government and railroad contracts, he was able to buy an enormous ranch – a stretch of land that ran 100 miles along the South Platte River in Colorado.

The great plains had previously been the domain of the buffalo. And their numbers were seemingly endless. In 1859 Luke Voorheese, an early settler, wrote that he'd traveled for 200 hundred miles through a single herd of buffalo between Colorado and Nebraska.

But, by the 1870s, buffalo hides were in huge demand for use as belts on steam engines in factories. And exterminating bison became the unofficial policy of the U.S. government. General Philip Sheridan's strategy to control the Indians was to exterminate their food supply. The army gave away free ammunition to buffalo hunters. Most importantly, the Union Pacific Railroad cut the prairie in half, bringing thousands of hunters into the plains.

By the mid-1870s, piles of bones like this one littered the West.



Four years after the Union Pacific railroad was completed in 1869, the entire buffalo herd south of the Union Pacific line was gone. And by 1883, virtually every bison in the United States – some 20 million animals – had been slaughtered.

They were replaced by cattle.

In the spring of 1867, in the first of many fabled "cattle drives," 35,000 head of cattle traveled the trails from Texas into the open ranges of Nebraska, Colorado, Wyoming, the Dakotas and Montana, searching for fresh pastures. Then 75,000 the next year. By 1871, more than half a million head of cattle a year were migrating northwards, into the plains where not long ago, "the buffalo roamed."

In the two decades following the Civil War, a total of more than ten million head of cattle would be pushed into the northern plains, along with half a million horses and 50,000 cowboys.

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In the spring of 1867, a 29-year old Illinois cattle broker, Joseph McCoy, figured he could reduce his costs by buying cattle “on the hoof” in the west and then shipping them, via specialized rail cars, to Chicago’s butchers. He pitched several railroads on the idea and was rejected by all of them, except the tiny Hannibal & St. Joseph Railroad. With its backing, he built the first train depot for cattle on 250 acres outside of a tiny hamlet in Kansas called Abilene.

The depot could hold 1,000 head… but 35,000 head arrived in the summer and fall of 1867. And the next year, 70,000 head arrived for shipment to Chicago. By 1869, 140,000 head were shipped from McCoy’s depot.

Abilene became a boom town, virtually overnight. McCoy had created the West’s first cattle town.

Other entrepreneurs copied the success of McCoy’s cattle depot, building farther and farther north and west along the growing spurs of the railroads. In Kansas, depots were built at Ellsworth, Newton, Wichita, Caldwell, Hays, Dodge City, and Hunnewell. In Montana, at Miles City. And, most famously, in Wyoming at Cheyenne. By the early 1880s, this 3,000-person cattle town boasted the highest per capita income in the world (as well as a capitol dome plated with gold leaf).

By the late 1860s, the value of U.S. meat production reached $1.4 billion, or 20% of America’s entire GDP. Beef production in America doubled between 1870 and 1900.

The cattle boom created other lucrative spinoff industries, too… restaurants and meatpackers, for instance.

In 1860, Lorenzo Delmonico was operating restaurants in three locations, including his flagship in New York at 5th Avenue and 14th Street. Delmonico invented the menu, and his chef, Charles Ranhofer, dreamed up most of the dishes that would be featured on menus for the next 100 years, like eggs Benedict, lobster Newburg, Manhattan clam chowder, oysters Rockefeller and, in honor of the 1867 purchase of Alaska, baked Alaska. But the prime attraction at Delmonico’s was always beef.

By 1900, there were 1,304 meatpacking plants in the U.S. The five leading meatpacking corporations (Swift, Armour, Morris, Cudahy, and S&S) employed more workers than any other industry in the country. Meatpackers would remain the largest industry in America (by employment) until the automakers surpassed them in the 1920s.

But these facts alone don’t tell the whole story of how Cheyenne became the richest city in the world. It wasn’t only cowboys that built America’s economy after the Civil War. Or even the Cattle Kings.

The cattle boom and everything that followed was enabled by a radically disruptive new technology that dramatically increased the productivity of ranching: *barbed wire*.

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Good Fences Make Good Neighbors

Invented by three farmers at a county fair in DeKalb, Illinois in July 1874, barbed wire fences significantly boosted cattle's odds of survival (until the meatpackers came calling) .

Separating bulls from each other (and protecting them from the other dangers of the open range) meant an 80% reduction in annual bull mortality. Barbed wire also meant that breeding could be accelerated and access to the best grasslands and watering holes could be controlled. And it reduced the need for cowboys to round up the cattle.

The economics were obvious: the bigger the ranch, the greater the returns from barbed wire fencing. Thus, demand for both ranch land and steel soared.

The leader in the barbed wire industry was John "Bet-a-Million" Gates, who, ignoring the patents of the original inventors, soon dominated the business through superior salesmanship. His American Steel and Wire grew like the Internet for a decade, with annual production exceeding one-million pounds after only two years.

In 1877, only three years after its invention, 12.8 million pounds of barbed wire were produced; 26.6 million pounds in 1878; 50.3 million pounds in 1880; and almost 100 million pounds by 1882.

The frenzy that followed will be familiar to anyone who remembers the Internet bubble of the 1990s. Seemingly endless demand for beef, amplified by the possibilities of the new barbed wire industry, created the impression of a "can't lose" investment proposition.

Many of America's richest families and individuals – Marshall Field, the Rockefellers, the Vanderbilts, the Flaglers, the Whitneys, the Seligmans, and the Ameses – invested heavily into cattle ranches. And the frenzy didn't stop with the Yanks.

The cattle mania was also the first genuinely global investment mania.

In 1875, a New York beef wholesaler, Timothy Eastman, pioneered using blocks of ice, fans, and air-tight holds on steamships to keep freshly butchered beef refrigerated on all eight of the transatlantic steamship lines. To market the beef, he delivered a free load to Queen Victoria.

At the time, approximately 1,000 families owned virtually all of the land in the British Isles. Many of these estates were assembled by Henry VIII during the English Reformation, when he confiscated all of Church's properties, and granted land and titles to his supporters. These estates generated much of the country's wealth, before the industrial revolution, in the form of rents paid by tenant farmers.

However, in 1849, the growing wealth and power of the merchant class led to the

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repeal of the Corn Laws – tariffs that kept grain prices high in Britain. Soon grains imported from India and Argentina made farming unprofitable. The incomes of the aristocracy suffered, with ground rents falling by 75% between 1872 and 1890, leaving English and Scottish landowners desperate for higher yielding land. As Timothy Eastman's shipment of American beef crossed the pond, rumors about the success of America's cattle ranches became the talk of London – and imported American beef rapidly began to replace local beef as the premium meat.

In 1879, the British parliament sent two members, Clare Read and Albert Pell, to the American West to explore opportunities. What they reported back launched the biggest investment mania the world had yet seen. Read and Pell wrote "*the acknowledged profits upon capital invested in cattle are 25% to 33% per year.*" On the basis of that report, enormous amounts of capital flowed from Great Britain into the American West.

Between 1879 and 1888, the British formed 36 new companies and raised $45 million to invest in cattle, an amount of capital equal to 5% of British GDP. A comparably sized investment would equal $150 billion today.

When an exciting new industry meets a flood of capital from investors – who are willing to pay almost any price just to get in the game – it rarely ends well.

In A.I., The "Steaks" Are High

Today, a similar influx of enthusiastic capital is pouring into artificial intelligence.

In the American West, a new technology (barbed wire) converted the incredible abundance of the Great Plains into an enormous economic engine – beef – the demand for which was widely believed to be unlimited.

Today, a new technology (A.I.) promises to convert the abundance of microprocessing power and computer networks into useful intelligence, the demand for which is widely believed to be unlimited.

Like all manias, faith in the unbridled future is enough for investors to plunk down huge sums of capital.

Consider the case of Mobius AI – a new startup founded earlier this year by four former Google researchers. According to a recent *New York Times* article, the founders "weren't sure what their product might be — just that it would involve A.I. technology that could generate its own photos and videos."

Despite having little more than four employees and an AI dream, it was enough for two of the top U.S. venture capital (VC) firms, Andreessen Horowitz and Index Ventures, to fund the business at a $100 million valuation. Similar deals have been struck for other brand new start-up companies. More than $50 billion was invested into AI startups in 2022.

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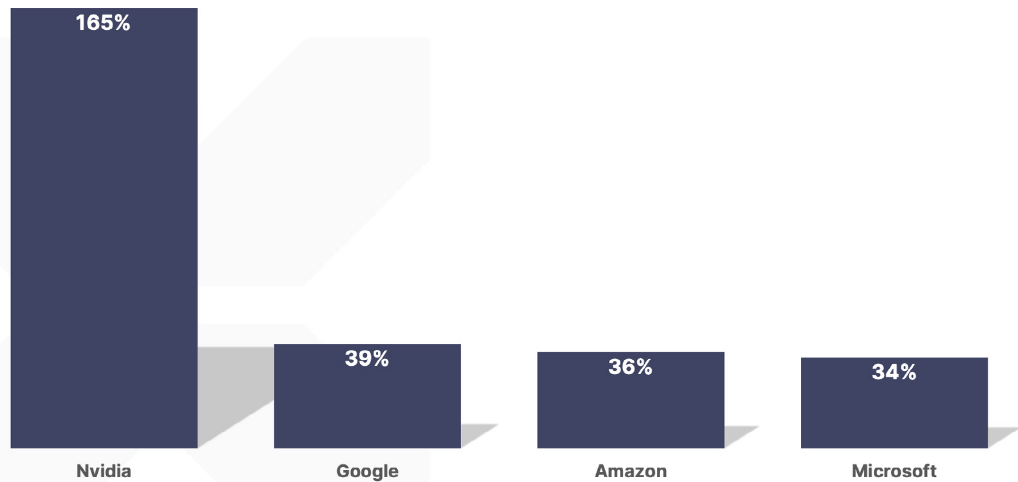
And far greater sums are being wagered in the public markets. Chipmaker Nvidia looks a lot like American Steel and Wire. Over the past five months, AI hype has fueled a stratospheric rise in Nvidia's market capitalization from $350 billion in January to $950 billion today (including a one-day increase of $200 billion alone on May 25).

And Google, Microsoft, and Amazon look a lot like the best western ranches. The valuations for these companies have also gained hundreds of billions of dollars in value in recent months, with share prices routinely surging on any AI-related headlines.



But let's not forget how the cattle boom ended.

"The Big Die-Up"

To go back to the plains... as capital poured into ranching and barbed wire began to privatize the endless prairie, there wasn't enough good land for grazing. By 1886 the herds weren't growing and, making matters worse, the price of beef was down about 20% from the year before.

Bubbles seem to attract pins. And the winter of 1886-1887 was the pin of the cattle boom.

No one had ever seen anything like it. In mid-January the snow started falling on the northern plains and it didn't stop for ten days. The temperature fell to 28 below, to thirty below, to 46 below zero. To sixty degrees below zero. It was the coldest winter on record.

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There was so much snow and so little grass left that the cows that didn't freeze to death, starved to death waiting for spring to arrive.

When the spring finally came, there were hardly any cows left. The cowboys, with so few cows to round up, called the winter the "Big Die-Up." More than a million head of cattle died. And virtually every large cattle ranch was wiped out, with losses of up to 80% of their herds.

Historian Christopher Knowlton, in his book *Cattle Kingdom,* wrote:

> ***"The deadly winter proceeded, almost biblical in its ferocity and duration, as though it had every intention of humbling and shaming anyone who had participated in the great cattle boom."***

In Colorado, the number of large-scale cattle companies was slashed from 58 in 1885 to just nine by 1888. In one telling example, the Poudre Livestock Company lost two-thirds of its herd.

Barbed wire was useless to keep out the snow. In most cases, investors in the boom lost everything.

Investors from Boston poured $2 million (roughly $6 billion today) into the Union Cattle Co., in 1883. Investors included the copper baron Alexander Agassiz, the stockbroker Henry Higginson (who founded the Boston Symphony Orchestra), and Quincy Adams Shaw, scion of the wealthiest family in Boston. The ranch, at its peak, held 60,000 head of cattle. It paid an annual 8% dividend for two years.

How? Not by selling cattle. Union Cattle bought at the peak, right before prices collapsed. Unbeknownst to its shareholders, the company *borrowed* $1.6 million to complete its land purchases and to pay the dividend.

After the Big Die-Up, it went bankrupt and was a total loss.

The same happened across the range, to virtually every ranch that was established during the boom.

The Swan Land & Cattle Co, for example. A joint-stock company founded in Scotland in 1883 with $3 million in capital (equivalent to almost $10 billion today) it was the largest in the West – a ranch the size of Connecticut. Somehow the company paid 20% annual dividends until it collapsed after The Big Die-Up. How? The manager, Alexander Swan, explained it this way:

> ***"In our business we are often compelled to do certain things which, to the inexperienced, seem a little crooked."***

The most famous victim of the cattle bubble was 28-year-old Theodore Roosevelt.

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Fleeing the grief of losing both his mother (typhoid) and his first wife (kidney failure) on the same day, Roosevelt moved to the Dakota Territory and established the Elkhorn Ranch in the summer of 1883. He went on to invest most of his family's wealth ($80,000 – a quarter of a billion today) into cattle, with disastrous results.

In the aftermath of The Big Die-Up, Roosevelt wrote to his sister: "*I wish I was sure I would lose no more than half the money I invested out here*." In all, Roosevelt would lose 75% of his herd and virtually all of his money.

How Not to Die

At Porter & Co. we have seen enough booms and busts to know that the real challenge investors face is survival, not underperformance. (For a reminder of how risky investing can be, just look at our **recent recommendation** of Icahn Enterprises.)

We have never seen a relatively wealthy person complain about their retirement because their portfolio has *only* averaged a 12% return over 20 years instead of a 14% return. But we have, unfortunately, seen that *most* retired people eventually suffer a catastrophic investment loss, resulting in a real decrease to their standard of living.

Our advice: eliminate that possibility by never investing in companies and sectors that have become swept up in speculative mania. Avoid risk like the plague, and you *might* survive.

Likewise, we believe the best way to produce great returns over the long term is to own the highest quality businesses in the world.

Could you make a fortune buying Nvidia today? Perhaps. Like the barbed wire purveyors during the 1800s cattle boom, Nvidia is the leading supplier of the critical infrastructure that promises to unleash an AI-driven productivity boom.

For now, business is booming. Earlier this week, Nvidia announced guidance for next quarter revenues to reach a record $11 billion, up 32% from its prior record of $8.3 billion in quarterly revenue. But investors are pricing in a bright future, with the stock price skyrocketing from $100 per share late last year to $390 today. Wall Street analysts currently expect Nvidia to generate $5.93 in earnings for 2024, meaning shares trade at an eye-watering 66x price-to-earnings multiple (compared with 18x for the S&P 500).

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Nvidia is now priced for perfection – it must continue growing and executing flawlessly in order to provide current investors with further upside from its lofty valuation. But history shows that when speculative fervor prices assets for perfection, any stumble can leave investors "out in the cold."

It was a freak snowstorm that decimated the cattle speculators in the 1880s. For a company like Nvidia, the potential threats range from competitors encroaching on its market share to a Chinese invasion of Taiwan – a growing geopolitical risk that could wipe out 25% of Nvidia's business overnight.

Forecasting the future competitive landscape of an emergent technology, or pricing in geopolitical risk is difficult. In order to justify Nvidia's current valuation, investors must grapple with a series of highly uncertain future scenarios.

We would rather own a world-beating business in a sector that is uniquely underappreciated by investors.

In that regard, we suggest studying and then owning one of the best businesses we have ever had the privilege to recommend to investors. It is, we would argue, one of the highest quality businesses *ever* created.

It's also largely immune to speculative mania because, quite frankly, it is boring. No one is running out to snap up shares of this company… except the richest men in the world.

And there's a very important reason to consider buying it *now*…

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"A Money-Printing Machine "

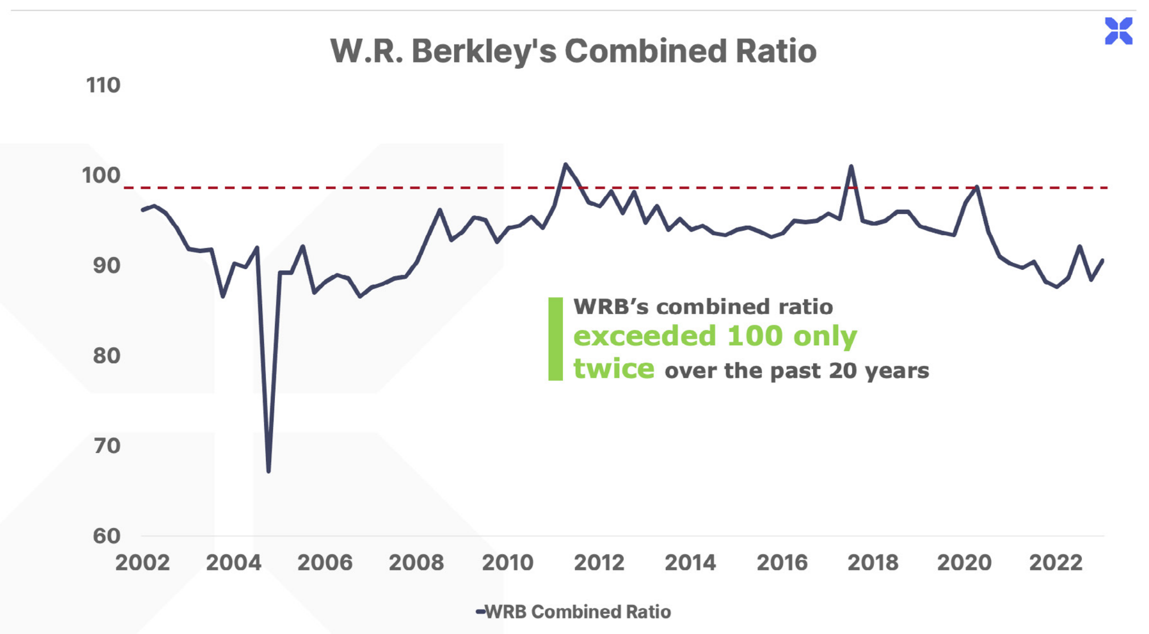
William R. Berkley, much like Warren Buffett, started buying stocks when he was 12 years old.

Then, while attending Harvard Business School, Berkley managed a $2 million mutual fund. He grew the fund to $10 million by the time he'd finished his MBA.

Like many great investors, Berkley figured out that property and casualty insurance is the best business in the world. It offers its customers financial surety in a world of constant risk. Property and casualty insurance is a service that's required by virtually every business and every family in the developed world. Without insurance, the modern world would simply not exist. And, like all well-run insurance companies, the company that bears Berkley's name, **W.R. Berkley (NYSE: WRB, $56)** enjoys a financial benefit like no other business: it has a *positive* "cost" of capital.

That is, rather than having to pay for capital – like a bank that must offer interest payments on deposits – W.R. Berkley receives all the capital it needs to pay claims and operate its business *for free*.

Assuming it can underwrite its insurance policies effectively (that is, accurately assess the risk of each potential policy), W.R. Berkley will earn a reasonable profit on the premiums it collects. When the policies it sells cover *both* the cost of the customer's claims and the company's operating costs, the firm's "combined ratio" will be less than 100% of its premiums.



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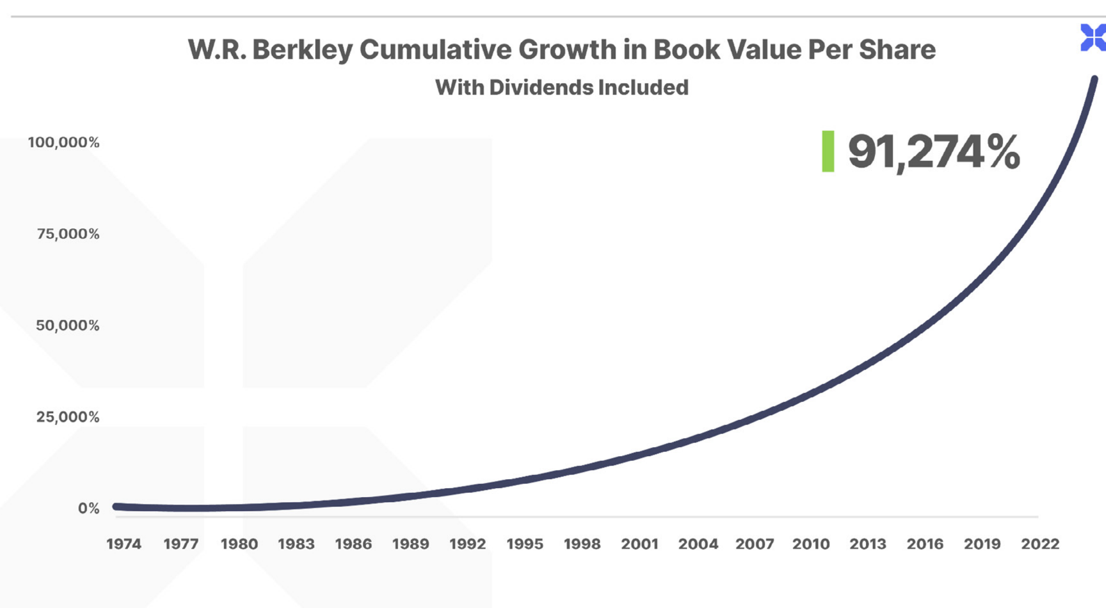
W.R. Berkley nearly *always* produces a combined ratio that's less than 100% of its premiums, which means W.R. Berkley starts out every year with a huge advantage against its peers and against all other companies in the S&P 500.

That's the primary reason why, since the company was listed in 1974, the average annual gain in book value per share has been 16.3% – roughly *double* what the S&P has produced in the same period. That's why Charlie Munger calls property and casualty insurance a "money-printing machine."

The chart below shows you what that looks like over time. That chart, by the way, isn't hypothetical. That's the company's actual increase in book value each year, plotted since 1974. The total increase: 91,274%.



If you think you're going to beat that result over a long period through day trading or guessing what the future holds for A.I. and chipmakers, you have our heartiest wishes – but it won't happen.

We have been recommending the shares of very high-quality property casualty insurance companies like RLI, Progressive, WRB, Travelers, and American Financial Group to investors for more than a decade. We believe these companies, when purchased at sensible prices, should be the foundation of every investor's portfolio. It is very difficult to produce better returns, with less risk, in any other investment vehicle.

And yet... judging by the reaction we get at conferences and during conversations with investors about these companies... we strongly suspect that most individual

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investors simply will not buy these stocks because they don't understand the jargon of the industry, or the key metrics you need to evaluate the businesses.

That's a shame, because analyzing these companies is easy. You need to focus on two things. First, as we mentioned above, the combined ratio, which measures the effectiveness of the company's core underwriting function, and secondly, the underlying investment portfolio.

When you buy an insurance company, you're buying two things: an **underwriting operation** and an **investment fund**.

You should understand how both things work.

Low Risk And Huge Float

The key to making sure that underwriters do their jobs well is to make sure they're compensated for profitable underwriting, not simply increasing the size of the insurance book. Underwriting insurance is a lot like making loans in the banking sector – anyone can lend money, but the trick is getting paid back in full. Likewise, when writing insurance policies, the key is to collect more in premiums versus the amount paid out in claims. This requires a laser-focus on risk management, and the discipline to write policies at high enough prices to secure a margin of safety against future claims.

In the same way that the history of banking is filled with disasters from those who extend cheap credit to bad borrowers, insurance companies that issue cheap policies to chase short-term premium growth, often find themselves underwater when those policies inevitably get paid out.

Aligning interests can be surprisingly difficult, especially because underwriting profitability is initially estimated and can only be finalized after the complete duration of the policy. But W.R. Berkely offers a masterclass in exactly how to do it.

In a nutshell, employees are compensated for underwriting policies that bring in reliable money for the company… that is, policies for safe, boring customers who aren't likely to total their cars or blow up their businesses. A good insurance company employee's job is to find these boring people, who will reliably pay premiums year in and year out until the expiration of the policy… and *only* grant policies to them.

W.R. Berkely encourages effective underwriting in several ways. First, it makes equity awards to employees only in the form of restricted stock units (not options), which vest only after the full duration of the policies underwritten in the period have expired. Secondly, equity awards are only granted on the basis of the company achieving meaningful return on equity targets (15% a year). And third, no shares so granted, even after they have vested, can be sold or pledged until a year

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after the executive has left the firm.

This culture of only paying for actual performance comes from the very top. And, because W.R. Berkley (the founder and executive chairman) owns more than 20% of all the shares, it's not hard to see why this company takes such a shareholder-friendly stance on compensation.

Beyond high-quality underwriting and carefully managing the company's expenses to ensure that the combined operating expenses (the combined ratio) don't exceed the revenues from selling premiums, the other critical factors that create substantial financial outperformance are the earnings from the company's "float."

An insurance company's float is simply the amount of capital that it's received in premiums, but has not yet paid out in claims.

Assuming the business is able to grow consistently and that it continues to underwrite with discipline, this becomes an ever-growing pool of capital from which it can derive very substantial earnings.

Warren Buffett has explained the concept of float to investors for years in his annual letters.

> ***"Insurers receive premiums upfront and pay claims later. In extreme cases, such as those arising from certain workers' compensation accidents, payments can stretch over decades. This collect-now, pay-later model leaves [insurers] holding large sums – money we call "float" – that will eventually go to others. Meanwhile, we get to invest this float for Berkshire's benefit. If our premiums exceed the total of our expenses and eventual losses, we register an underwriting profit that adds to the investment income our float produces. When such a profit occurs, we enjoy the use of free money – and, better yet, get paid for holding it."***

W.R. Berkley's float allows it to hold $22.9 billion in investments (as of the end of 2022).

Historically, W.R. Berkley's investment returns haven't been exceptional because the company takes an extreme stance on financial stability. It holds virtually all of its investments in high quality bonds – unlike Berkshire Hathaway, which, as everyone knows, owns a lot of common stock.

Specifically, Berkley holds $17.7 billion (77%) of its investment portfolio in short-term, A-rated bonds or short-term loans. It only owns $1.1 billion of equities (4.8%). The balance is held in roughly equal amounts of private equity funds, real estate, and an arbitrage trading account that earns fixed-income-like returns.

This ultra-conservative stance has been a drag on performance for many years,

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especially as bond yields fell year after year and dwindled to virtually nothing.

But rather than chasing yield by moving the average duration of their portfolio higher (like so many banks did, to their regret), William Berkley figured, wisely, that sooner or later inflation would return with a vengeance. And he positioned the company's portfolio to capitalize when that day arrived.

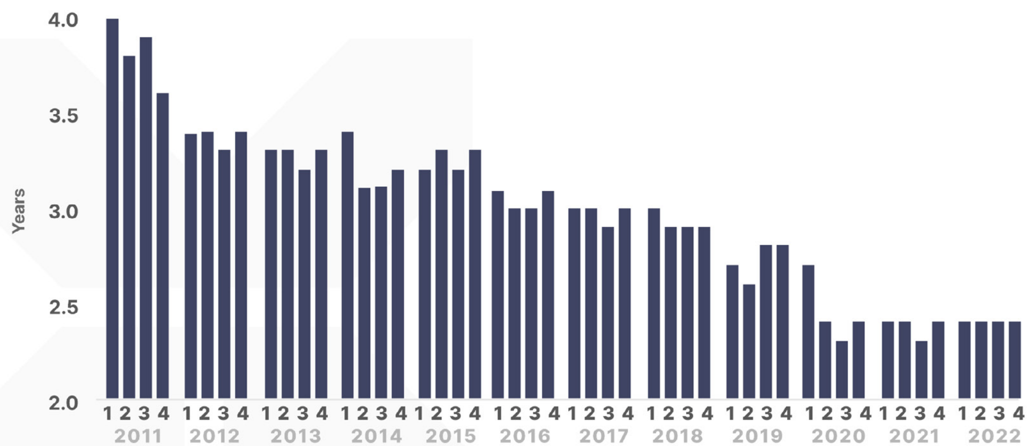
As short-term interest rates dwindled to almost nothing in the face of Covid, rather than trying to capture extra yield by moving into longer duration bonds, W.R. Berkley moved the average duration of its bond portfolio *down*, to the shortest average duration in the entire industry.

As the chart below shows, for the last decade the company has steadily reduced its exposure to the risk of inflation. It also hedged against that risk in other ways, like buying real estate in addition to bonds.

And, as interest rates have surged at their fastest pace in four decades in the last 18 months, the brilliance of that long game came into sharp relief.

Berkley's Bond Strategy Pays Off

The company is perfectly positioned for today's higher interest rate environment, as it's maturing bonds have been reinvested at higher yields, producing *outstanding* investment income last year.



The numbers above the year correspond to the bond duration at the end of the quarter of each respective year.

As the CEO, W.R. Berkley, Jr. explained in a recent letter to shareholders:

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> *"Our investment returns were outstanding in 2022. We positioned ourselves at the beginning of the year to reflect our concerns about inflation and concomitant rising interest rates... Our assessments proved to be fortuitous. Interest rates went up substantially with an inverted yield curve, but because of our portfolio's position, we did not suffer consequential capital losses. Our common stocks appreciated while the market depreciated and our cash flow and short-duration portfolio allowed us to reinvest at substantially higher rates. We realized additional gains with the sale of significant real estate holdings in the UK and the USA. The overall result was that our investment portfolio, both in terms of investment income and capital gains, delivered exceptional results.*

Net investment income for last year was $779 million (up 16% over the previous year).

And it's continuing to increase as the company's bond portfolio "rolls over" into much higher yielding securities.

In the first quarter of 2022, the company's net investment income grew 29% over the first quarter of 2022, and is on pace to exceed $1 billion this year.

Even more impressively, almost all of Berkley's competitors saw their book values fall last year, substantially, because the value of their bonds fell as interest rates rose. Meanwhile, book value at Berkley increased and the company was able to return $132.6 million to investors through regular dividends, an additional $102.6 million in special dividends, plus another $94.1 million via share repurchases in 2022.

Ironically, the company's shares have sold off this year, as financial stocks, in general, haven't done well because of rising interest rates and the corresponding falling value of longer-duration bonds. Nobody seems to care, yet, that W.R. Berkley structured its balance sheet for precisely this environment. Investors cashing the company's dividend checks this year will definitely notice.

Beyond the two standard ways to evaluate W.R. Berkley (as an underwriter and as an investment fund) there's one other very important thing to note W.R. Berkley doesn't like to buy new businesses. It likes to build them. In this way it's something like a venture capital insurance company. Of the firm's 59 different operating companies, 52 were organized and created internally. Only seven were added through acquisitions.

Some examples of W.R. Berkley's internally-created companies include Berkley Life Sciences in 2007, a specialty insurance company that caters to healthcare and pharmaceutical companies, which underwrites policies for things like clinical drug trials and product recalls. In 2008, the company launched Berkley Asset Protection to provide insurance against theft or damage to fine art, jewelry and other high-

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value assets.

We cannot stress enough how rare this is and how valuable to shareholders over the long term. There's never going to be a big write-off here of an expensive acquisition that's gone sour. And instead of using the company's capital to buy other businesses, that capital instead is returned to shareholders.

The combination of these factors – the company's excellent underwriting, its ultra-safe investment portfolio, its dedication to organic growth, and the capital efficient structure of the industry – all result in a business that's extremely profitable and extremely safe.

It is, without any question, one of the greatest businesses in the world.

So... what should you be willing to pay for it?

Buffett's Bargains – And How Berkley Stacks Up

Remember, in an insurance company you're buying two things: the stream of earnings from the underwriting and the underlying investment portfolio – the "float."

Over many years, we've studied Buffett's acquisitions in the insurance sector. In 1995, Buffett bought the 49% of GEICO, the second largest U.S. auto insurer, that he didn't already own for $2.3 billion, which added $3 billion to Berkshire's float and $750 million in book value. Ergo, he paid $0.61 for every dollar of float and book value. Measured the same way, he probably overpaid for General Re in 1998: that cost him $0.94 for every dollar of float and book value. On the other hand, his original investment into property and casualty insurance, the 1967 acquisition of National Indemnity, was a bargain: $0.51 for every dollar of float and book value.

Last year, Buffett bought Alleghany – another high-quality property and casualty insurance company that we had long recommended to investors. He paid $11.6 billion and got $14 billion in float plus $9.2 billion in book value – another bargain, about $0.50 per dollar of float and book value.

Today W.R. Berkley has roughly $25 billion in float and $7 billion in book value. Its shares are worth $14.8 billion, in total. You're paying $0.46 per dollar of float and book value. That's as cheap as we've seen it trade in a long time.

We suspect the market is treating it like every other financial firm, where the value of those long-term bond portfolios is causing big writedowns and even bank failures.

But as the dividends will continue to prove, W.R. Berkley is in a class by itself. In the first quarter, W.R. Berkley returned $293.8 million to shareholders, in the form of $158 million in dividends and $135 million in share repurchases. Annualized, that's

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over $1.1 billion in combined capital return, a combined yield of 7.8%.

As a final valuation measure, W.R. Berkley trades for just 12x the company's expected earnings for 2023 – a discount of roughly 35% versus the S&P 500. A world-class company like W.R. Berkley should command a premium valuation, and historically it has – trading in a range of roughly 20 - 30x earnings for most of the past five years.

Mr. Market has thrown the baby out with the bathwater by lumping W.R. Berkley into the same bucket as other distressed financial companies saddled with underwater investment portfolios.. But as we've shown today, W.R. Berkley is one of the rare financial companies that is benefiting from higher interest rates. This misperception has created the rare opportunity to buy a wonderful company at a wonderful price.

Action to Take: Buy shares of W.R. Berkley (WRB) up to $62 per share.

New to the Porter & Co. Portfolio? Start With Our Top 3 "Best Buys" Today

Our goal at Porter & Co. is to bring you world-class investment research, focused on "inevitable" businesses that you can buy and hold forever. This is the surest and safest path to building permanent wealth.

While we don't believe in timing the market, we do keep a constant eye out for bargains. In each edition of *The Big Secret*, we highlight three current portfolio picks that are at an attractive buy point. In addition to today's recommendation, we suggest you focus on these:

1. Dirty energy is never going away… Instead, it will just take safer, cleaner forms, like nuclear energy. **BWX Technologies (BWXT)** is **A Matter of National Security**, and a bargain at 16x enterprise value (i.e., the combined value of equity and debt) to operating income. BWXT has been a leading manufacturer of nuclear reactors and components since the birth of the nuclear power industry over 100 years ago. BWXT is responsible for powering the Navy's submarines and aircraft carriers as well as all the mechanical equipment in the engine room. The company's recession-proof business with the U.S. government is based on long-term contracts that provide a high degree of cash flow stability and predictability. It's also pioneering a revolutionary "bring-your-own-energy" concept for the commercial sector: small modular nuclear reactors (SMRs). These portable reactors could rip up the playbook of energy as we know it today, making nuclear energy a safe, cheap and sustainable global energy source.

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2. **Credit Acceptance Corp (CACC)** is a leading subprime auto lender, which we call the **Goldman Sachs of White Trash**. The business of making subprime loans isn't glamorous, but it's tremendously profitable and highly capital efficient. CACC has generated 63% free cash flow margins over the last five years, and today trades at just 14x earnings. (It's at a buy point of $420 per share, or less than 15x earnings.) Shares have recently sold off on fears of a subprime auto lending meltdown, but as we explained in a recent **portfolio update,** CACC is uniquely positioned to benefit from spiking default rates – and that's already showing up in its latest quarterly earnings report. With lending standards tightening and auto delinquencies on the rise, more consumers are entering the subprime category. This was confirmed last quarter as CACC's loan growth surged by 26%.
3. **Viper Energy Partners (VNOM)** is an oil and gas royalty company – the best business in the energy sector, and the **Secret Behind T. Boone's Fortune**. Unlike oil and gas producers, VNOM never spends a dime searching for oil or drilling holes deep into the earth. It simply owns the land upon which other companies drill, and collects a percentage of the cash flow. That makes it one of most capital efficient businesses you'll find anywhere, with 80% free cash flow margins. VNOM funnels its profits directly to shareholders, instead of back into the ground. VNOM currently trades at a 15% free cash flow yield – the best valuation since the depths of the COVID-19 pandemic. The company is returning capital to shareholders through a 3.6% dividend yield and a repurchase program that has reduced outstanding units by 10% over the last 18 months.

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Portfolio Update

The Big Secret on Wall Street PORTFOLIO

ENERGY & COMMODITIES	Ticker	Description	Purchase Date	Cost Basis	Closing Price	Yield	Income Received	Total Return	Status	Risk Rating (1 - 5)
EQT CORPORATION	EQT	U.S. Gas-Focused E&P	06-03-2022	$47.99	$36.49	1.25%	$0.45	-23.03%	Buy Under $50	4
TELLURIAN INC.	TELL	U.S. LNG Exporter	06-17-2022	$3.53	$1.27	0.00%	$0.00	-64.02%	Buy Under $5	5
VIPER ENERGY	VNOM	Oil and Gas Royalty	09-02-2022	$30.58	$26.61	4.96%	$1.31	-8.70%	Buy Under $34	3
BWX TECHNOLOGIES, INC.	BWXT	Nuclear Power Equipment	12-23-2022	$58.24	$62.48	1.41%	$0.23	7.68%	Buy Under $65	3
BLACK STONE MINERALS	BSM	Oil and Gas Royalty	02-17-2023	$15.90	$15.97	12.02%	$0.48	3.43%	Buy Under $18	2
AMERIGO RESOURCES	ARREF	Base Metals	03-31-2023	$1.21	$1.06	7.55%	$0.00	-12.40%	Buy Under $1.35	4
BITCOIN	BTCUSD	Cryptocurrency	05-12-2023	$27,179.90	$26,481.55	0.00%	$0.00	-2.57%	Buy Under $35,000	4
BATTLESHIP STOCKS										
ALTRIA	MO	Tobacco Maker	07-15-2022	$42.24	$44.67	8.42%	$2.82	12.43%	Buy Under $50	1
PHILIP MORRIS	PM	Tobacco Maker	07-15-2022	$90.18	$90.76	5.60%	$3.81	4.87%	Buy Under $100	1
CREDIT ACCEPTANCE CORP	CACC	Consumer Finance	07-29-2022	$575.91	$434.26	0.00%	$0.00	-24.60%	Buy Under $600	3
NOVO NORDISK	NVO	Pharmaceuticals	10-28-2022	$106.67	$162.44	2.15%	$1.19	53.40%	Hold	2
WINMARK CORPORATION	WINA	Specialty Apparel Stores	09-16-2022	$218.96	$330.80	0.97%	$4.40	53.09%	Hold	1
ACTIVISION BLIZZARD	ATVI	Video Games	03-03-2023	$77.71	$77.14	0.00%	$0.00	-0.73%	Buy Under $82	2
DOMINO'S PIZZAS INC	DPZ	Restaurants	02-27-2023	$300.00	$304.50	1.44%	$1.21	1.90%	Buy Under $300	3
DREAM FINDERS HOMES, INC.	DFH	Homebuilder	04-28-2023	$14.83	$18.02	0.00%	$0.00	21.51%	Buy Under $16	4
FRANCO-NEVADA CORP	FNV	Precious Metals Streamer	05-12-2023	$154.74	$145.55	0.93%	$0.00	-5.94%	Buy Under $170	2
W.R. BERKLEY	WRB	P&C Insurance	05-26-2023	$56.10	$56.10	0.71%	$0.00		Buy Under $62	2
INCOME & DISTRESSED DEBT										
MICROSTRATEGY INC	CUSIP: 594972AC5	2025 Convertible Bond	10-14-2022	$758.00	$933.75	0.80%	$3.75	23.68%	Hold	4
QURATE RETAIL, INC.	QRTEP	8% Cumulative Preferred Stock	01-20-2023	$40.64	$34.80	22.99%	$2.00	-9.45%	Buy Under $50	3
ANNALY CAPITAL MANAGEMENT	NLY	Real Estate Investment Trust	02-03-2023	$23.75	$17.79	19.79%	$0.65	-22.36%	Buy Under $24	2
SABA CAPITAL & INCOME OPPORTUNITIES FUND	BRW	High Yield Bond Fund	03-17-2023	$8.07	$7.91	13.50%	$0.09	-0.90%	Buy Under $9	3
OAKTREE SPECIALTY LENDING CORP	OCSL	Specialty Investments	03-31-2023	$18.57	$18.52	11.88%	$0.00	-0.27%	Buy Under $22	2
BETTER THAN THE MARKET										
CAMBRIA SHAREHOLDER YIELD	SYLD	Yield Focused ETF	01-06-2023	$61.22	$56.04	2.77%	$0.57	-7.52%	Buy Under $65	2
WATCHLIST										
NVR, INC.	NVR	Homebuilder	NA	-	$5,635.22	0.00%	-		Buy Under $3,500	
FREEPORT-MCMORAN	FCX	Base Metals	NA	-	$33.63	1.78%	-		Waiting For Recession	
SOUTHERN COPPER CORP	SCCO	Base Metals	NA	-	$65.19	4.60%	-		Waiting For Recession	
SHERWIN-WILLIAMS	SHW	Specialty Chemicals	NA	-	$226.51	4.27%	-		Buy Under $150	
HALL OF SHAME										
ICAHN ENTERPRISES	IEP	Specialty Investments	12-09-2022	$50.39	$20.25	39.51%	$4.00	-51.88%	Sell	

Disclaimer: this hypothetical portfolio should not be considered investment advice or a recommendation to buy/sell any financial instrument. For informational purposes only. Investors should perform their own due diligence before buying or selling any financial instrument. No express or implied guarantee of accuracy or applicability to real-world trading. Risk Ratings are based on a security's fundamentals and business model rather than its current valuation.

IEP – The Inaugural Entrant into The Porter & Co. Hall of Shame

We recommend selling Icahn Enterprises.

For our track record, we will document a 52% loss. That's based on Thursday's closing price (including the upcoming dividend payment, which IEP holders as of May 19 are entitled to receive).

During our research into IEP's financials, the key risk factor we overlooked was the fact that Carl Icahn had pledged roughly two-thirds of his units as collateral for a margin loan. That crucial data point was hidden on a footnote on page 124 of the company's annual report. Given the size of this margin loan, and the potential for a forced sale from the single largest IEP holder, this information should have been included in the listed risk factors. The company should have also disclosed all of the documentation around these margin loans.

Even so, the oversight is our fault. We should not have made this recommendation. We compounded our error by not exiting immediately when we learned about this

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complication from the report by short seller Hindenburg Research last month.

The IEP unit price has now fallen by over 60% from recent highs to $20 in the wake of the Hindenburg report. With limited disclosures on the specifics of the margin loan, we can't know for sure what price would trigger a forced sale from Icahn's lenders. And despite Icahn's public assurances that no amount of financial pressure could force him to sell, we believe that risk is high. We had hoped that Icahn would find additional financing to remove the risk of this margin debt, but that seems very unlikely to happen now.

How this plays out is impossible to predict. As such, we are exiting the position in our model portfolio.

We are, frankly, embarrassed by this entire episode. To forever remind us of this mistake, we are creating a new "Hall of Shame" section in our portfolio. Inclusion in our Hall of Shame will not be predicated on a bad investment outcome (you can take a loss even when you haven't made any serious mistakes), but on failures in our research that lead to investment losses.

We aren't perfect.

Action to Take: Sell shares of Icahn Enterprises (IEP).

As Novo Patients Get Smaller, Novo Gets Bigger

In brighter news, shares of Novo Nordisk are up 54% since our **recommendation** on October 28, 2022.

Rapid growth in obesity and diabetes drugs helped Novo clear a new record high of $7.7 billion in quarterly revenues, a 27% increase from $6.4 billion in Q1 2022. Net income likewise hit an all-time high at $2.9 billion, up 37% from $2.1 billion in Q1 2022 (note: Novo reports its financials in its home currency of the Danish krone, but we've converted all figures to U.S. dollars for convenience).

Booming demand for Novo's new GLP-1 weight loss and diabetes treatments are powering the company's rising earnings and share price.

This includes Novo's blockbuster weight-loss drug Ozempic, which continues setting new record sales volumes, reaching $2.8 billion in Q1 – up 55% from $1.8 billion over the last year. Novo's pill-based GLP-1 weight loss drug, Rybelsus, is growing even faster, with sales rising 102% over the last year to reach $628 million in Q1.

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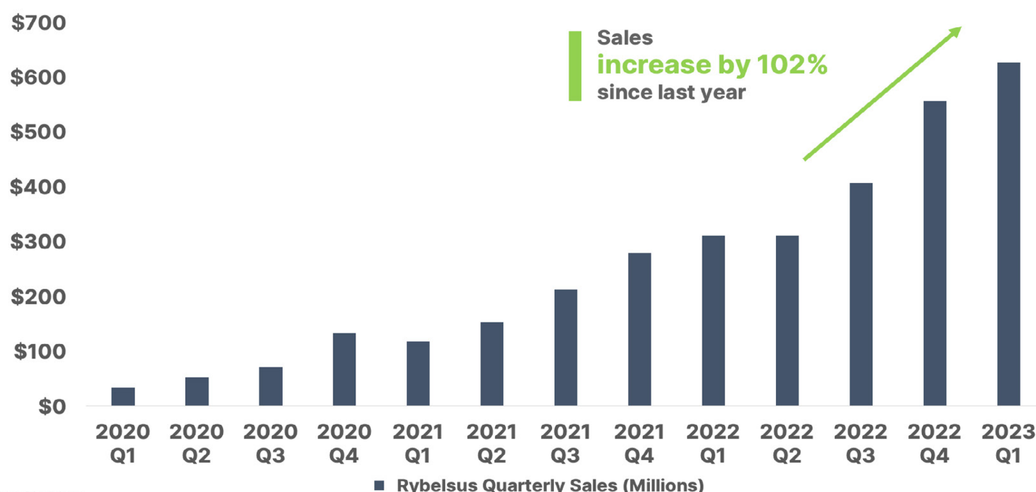

Meanwhile, Novo's GLP-1 diabetes treatments are also booming. This includes Wegovy, which generated $658 million in sales for Q1, up 211% over the last year. Novo's other key GLP-1 diabetes drug, Saxenda, grew sales by 63% over the last year to reach $473 million.

Rapid growth in GLP-1 diabetes treatments has offset Novo's declining insulin sales, which fell by 11% in Q1. Traditional insulin is gradually taking a smaller role in Novo's business, given the low margin and low growth prospects for this segment. However, the company continues investing in advanced insulin products, with the potential for higher growth and greater profit margins. This includes a new product called Icodec, which only requires a once-weekly injection, representing a major improvement from traditional insulin that must be injected once or multiple times per day.

Novo recently submitted Icodec for regulatory approval in the EU, the U.S. and China.

The other detracting segment in Novo's results came from its rare disease portfolio, where sales fell by 16%. This segment includes drugs for endocrine disorders and hemophilia, and part of the decline was caused by a temporary decline in manufacturing capacity. However, at just 9% of Novo's revenues, the rare disease segment is a minor contributor to the overall business.

Despite these modest headwinds from the insulin and rare diseases sectors, Novo's obesity and diabetes portfolio – which together make up 91% of its business – is firing on all cylinders, with total growth of 33% across all drugs in these two key categories. By doubling down on the highly profitable GLP-1 compounds,

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Novo's profit margins are rising. Over the past year, Novo's net income margins have increased from 33.8% in Q1 2022 to 37.1% in Q1 2023.

Novo's Supply Chain Woes Are Ending

Novo has grappled with supply chain constraints over the past year, as the popularity of GLP-1 drugs Ozempic and Wegovy have overwhelmed the company's ability to meet demand. But those constraints are now easing.

When we spoke with management in mid-May, they noted that they anticipate building out enough excess capacity for GLP-1 to avoid any further shortfalls over the coming years. The company struck a deal with a second contract manufacturer for Wegovy in April 2023, and is currently pursuing another potential investment in a third production facility for GLP-1 compounds.

As a result of Novo's expanding GLP-1 production capacity, coupled with ravenous demand, Novo boosted its 2023 outlook for both sales and operating profits when it reported Q1 earnings on May 4. The company is now guiding investors to expect growth of 28 - 34% for revenue and 24 - 30% for operating profits. Analysts currently expect Novo to grow net income by a total of 63% from year-end 2022 through year-end 2024:

Best of all, thanks to Novo's high capital efficiency – including free cash flow margins of 37% – the company consistently funnels a substantial portion of earnings back to shareholders, through dividends and share buybacks. Over the past five years, Novo has increased its quarterly dividend by 50% from $0.80 to

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$1.20 per share. Over the same period, the company also reduced its share count by 10%, from 1.9 billion to 1.7 billion. We expect Novo will continue funneling a large portion of its earnings to investors.

In addition to weight loss applications, a growing body of anecdotal evidence suggests that GLP-1 can enact powerful behavioral changes across a wide swath of addictive behaviors, like smoking, shopping and binge eating.

Scientists have also begun studying the GLP-1 compound in animals, and the results are promising, according to the *New York Times*:

> ***"Rats, mice and monkeys receiving GLP-1 receptor agonists have been shown to consume less alcohol and exhibit less of a desire for it than those that are not given the medication. (Animal studies involving these chemicals and drugs like nicotine, opioids and cocaine have reported similar findings.)"***

This research is in very early stages, but it represents the potential for a much greater opportunity set from novel GLP-1 drug applications going forward.

Novo is the best positioned company to benefit from this opportunity, as the industry leader in GLP-1 drugs, with 54.4% of global market share.

We continue recommending investors hold shares in Novo Nordisk.

Next, let's move on to the energy section of the portfolio, which has struggled recently under the weight of depressed oil and natural gas prices.

IEA Warns of Looming Oil Shortage

Oil prices have declined by roughly 10% so far this year, falling from $80 to around $72 per barrel. Despite this price weakness, the global supply and demand fundamentals remain bullish, with rebounding Chinese demand as a key catalyst.

Last year, Chinese oil demand fell by roughly 2 million barrels per day (b/d) last year as a result of the country's zero-COVID policy that enforced strict economic lockdowns. China began phasing out those restrictions last December, and the Chinese economy has now fully reopened. The rebound in Chinese demand has been slower than many analysts forecasted, but it is gradually gathering pace.

The latest estimates from the International Energy Agency (IEA) indicates global oil demand will rise by 2 million b/d to reach a record 101.9 million b/d by year-end 2023, with nearly 90% of this growth driven by the reopening of China's economy. Notably, the IEA's global demand forecast assumes an economic slowdown in western economies, including the U.S. and Europe, which it predicts will be more than offset by recovering demand in China in the second half of 2023.

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The supply side of the oil equation will further support prices in the second half of the year. The OPEC+ cartel recently announced 1.16 million b/d of production cuts, which followed Russia's 500,000 b/d production cut in March. Meanwhile, U.S. shale, the former engine of global oil supply growth, is struggling to add production onto the market.

U.S. oil output has stagnated in a range between 12.2 - 12.3 million b/d so far in 2023, as management teams among U.S. energy companies are choosing to return capital to shareholders instead of investing in more production growth. This flatlining U.S. oil production compares with pre-COVID annual growth rates of 1 - 1.5 million b/d from U.S. producers.

Adding it all up, the IEA expects that total supply from the OPEC+ cartel will fall by 1.4 million b/d from March - December of 2023, compared with non-OPEC+ growth of roughly 1 million b/d. The net balance will leave the global oil market facing a supply contraction of 400,000 b/d through year-end.

As a result, the IEA currently projects a growing potential for "a substantial supply deficit to emerge" in the second half of 2023. The market is already showing signs of tightness, with the latest global oil inventory data indicating a contraction of 38.9 million barrels in March.

Zooming out, it's worth noting how far the narratives, and the fundamentals, have shifted in the last few years. During the depths of the COVID-19 in 2020, even CEOs at some of the world's largest oil producers were casting doubt on the future of oil demand, as seen in this **September 2020 headline from The Guardian:**

> **Global oil demand may have passed peak, says BP energy report**
>
> **Oil will be replaced by clean electricity, BP predicts, as demand may never recover from Covid-19 pandemic**

Investors who bought energy stocks during the pandemic made fortunes. However, even as the outlook for fossil fuel demand has flipped 180 degrees from existential crisis to new record highs in demand, Mr. Market has yet to reflect this shift in the valuations across the sector.

This includes our top energy pick, Viper Energy Partners (VNOM), which today trades at valuation levels last seen during the depths of COVID-19.

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Despite Massive Cash Flow, VNOM Trades At A Crisis-Level Discount

Viper Energy Partners reported its fourth consecutive quarter of record royalty production volumes when it released Q1 results on May 1, reaching 34,967 barrels of oil-equivalent per day (boe/d). This reflects 11% growth over the past year.

Although oil prices have steadily declined from a high of $130 per barrel following Russia's invasion of Ukraine in March 2022, the company generated $834 million in revenues over the past four quarters – or just 4% short of an all-time high. Thanks to its capital efficient royalty model (as described in our **original recommendation in September**), the company converts 80% of revenues into free cash flow, including $671 million over the last four quarters.

Compared to VNOM's $4.4 billion market capitalization, the company trades for a 15% free cash flow yield – the highest in the company's history, outside of the 2020 pandemic-driven selloff in its share price:

In the private market for mineral interests, 15% free cash flow yields are practically unheard of. VNOM has started to capitalize on this "valuation disconnect" by reducing dividends and increasing share repurchases, effectively buying a greater ownership stake in its own assets at deeply discounted prices.

On August 1, 2022, VNOM reduced its quarterly base dividend to $0.25, down from the previous $0.67 base dividend rate. The company simultaneously announced an increase in its buyback authorization from $250 million to $750 million. Management explained its rationale for this shift the following day:

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"We can't go buy a mineral in a Tier 1 area for anything close to where we're trading at today in the public market. So I think it just continues to highlight the disconnect between oil and the public markets versus oil in the ground. And so as a result, we're going to be leaning into the buyback here."

In other words, the market is providing an opportunity for VNOM to buy into its own discounted mineral interests through unit repurchases. This, in turn, increases investor ownership of VNOM's assets at deeply discounted values.

We agree with this "buyback over dividend" strategy, because paying out cash via dividends is a one-time payment. Repurchases, on the other hand, offer investors a perpetual increase in their ownership of VNOM's assets – which will pay dividends for years to come.

Income-focused investors may not be thrilled with the lower dividend. But for long-term investors, this strategy will result in an increased ownership stake in a cash flow juggernaut.

In the first quarter, the company repurchased over 1 million units – representing 1.3% of the outstanding units. Since January 2022, the company has reduced the share count by 10% from 79 million to 72 million shares outstanding.

Meanwhile, VNOM's royalty production volumes will continue growing, thanks in large part to its strategic relationship with Diamondback Energy. As we explained **in the original recommendation**, VNOM is Diamondback's key mineral leasing partner. Since Diamondback owns 58% of VNOM, both parties are aligned to ensure VNOM gets access to Diamondback's key mineral leasing deals, and thus a growing revenue and cash flow stream. Given Diamondback's leading position and growth rate in the heart of America's most prolific oil basin, the Permian, it's an ideal royalty company partner.

Unlike many of its peers that have halted production growth, Diamondback is growing its oil output at double-digit rates, including an 11% increase in production for Q1. As Diamondback grows, VNOM is along for the ride – by striking leasing deals for mineral rights on its new drilling areas.

VNOM acquired 819 net royalty acres in Q1, or about 3% of its total 27,134 acreage footprint, which included 696 net acres from Diamondback. This will support VNOM's guidance for 8% growth in royalty production volumes in Q2 and Q3 of this year. Best of all, this growth comes with no capital expenditures from VNOM – which means 80% of this revenue growth can convert to free cash flow, which can then be returned to shareholders.

Meanwhile, despite the reduced dividend, VNOM still offers a solid 3.7% yield at current unit prices of around $27.

VNOM's impressive growth in revenues and free cash flow – which we expect will

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continue – and its crisis-level 15% free cash flow yield makes VNOM one of our top picks.

We continue to recommend investors buy Viper Energy Partners (VNOM) up to $34 per unit.

Next, let's move on to the natural gas side of the portfolio.

As we've **previously written**, global natural gas prices suffered from a record-setting global heat wave last winter. In addition, America's second largest liquefied natural gas (LNG) exporting facility, Freeport LNG, suffered an explosion and went offline for over six months for repairs. This added more excess supply onto the U.S. gas market by taking nearly 20% of U.S. LNG exports offline.

Freeport has since restarted, and with winter in the rearview, these two temporary overhangs on the market have now passed. However, this one-two demand punch left the U.S. gas market with a 400 billion cubic foot (Bcf) surplus, sending prices to a low of $2 per thousand cubic feet (mcf) by the first quarter, before rebounding to around $2.50 today.

The market is currently in the process of working through the winter gas surplus. Current U.S. gas inventories are 340 Bcf, or 17% greater than the five-year average for this time of year. This surplus will likely keep a lid on gas prices until 2024, when a series of new LNG export facilities begin coming online. Those new facilities will boost U.S. LNG exports by nearly 50% through 2026, providing a major tailwind for prices once today's storage surplus gets worked off.

Natural gas exploration and production company EQT (EQT) is well-positioned to ride out today's temporary gas glut, with record cash flows even despite today's low-price environment.

The "Gods of Gas" Unleash The Cash

On April 26, EQT reported record first quarter free cash flow of $774 million, up 33% from $580 million in Q1 2022. The company offset low gas prices with a strong hedge position, which places a floor on 62% of its forecasted 2023 production volumes at $3.38 per Mcf.

When the Rice brothers, whom we dubbed the **Gods of Gas** in our original EQT recommendation, took over the management of EQT in 2020, they outlined a vision for transforming the company into a cash-generating monster. Their strategy revolved around two basic ideas: cutting costs and making smart acquisitions... like buying up 335,000 acres of prime Appalachian gas assets from Chevron at pennies on the dollar in fall 2020, after COVID-19 decimated the natural gas industry.

This acquisition, along with operational efficiencies that slashed EQT's production costs, is now paying off in the form of a cash flow windfall. Over the last 12

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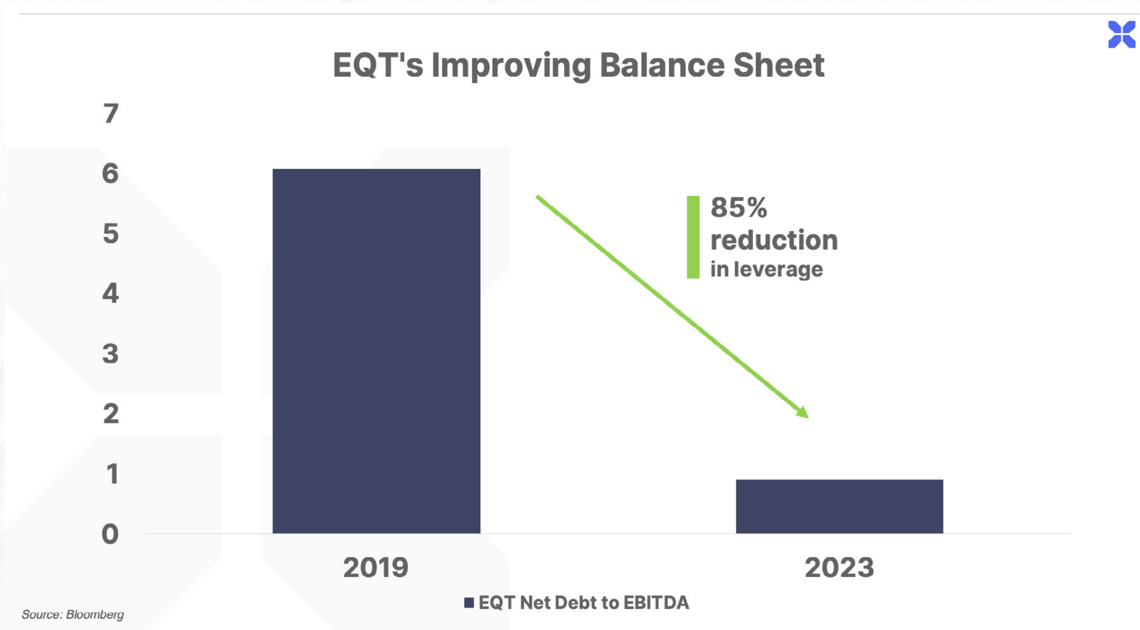
months, EQT generated a record $2.5 billion in free cash flow, or a 10-fold increase from 2019 levels just before the Rice brothers took control of the company.

EQT is directing most of this cash flow windfall to improving the company's balance sheet, reducing net debt by nearly 50%, from $6.2 billion in late 2021 to $3.3 billion today.

This debt reduction has reduced EQT's leverage ratio down to just 0.9x net debt to EBITDA (earnings before interest, tax, depreciation and amortization) – a nearly 90% cut from the company's 6x leverage ratio in 2019.



With the balance sheet in great shape, we now expect the company to return a substantial portion of free cash flow back to shareholders via dividends and buybacks. The company currently pays out a $0.60 annual dividend, for a 1.7% yield at its recent share price of $36. It also repurchased $200 million of shares in the first quarter, reducing its share count by 1.3% from 365 million to 360 million.

Looking ahead, even with the conservative assumption that today's depressed gas prices persist, the company expects to generate over $12 billion in free cash flow from 2023 - 2027. That's close to EQT's current market capitalization of around $13 billion.

In other words, at today's share price, the company could almost buy back the entire share base of the company with free cash flow over the next five years.

We don't expect natural gas prices to remain depressed through 2027, and so this forecast could prove conservative. With a wave of new LNG export terminals

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coming online from 2024 - 2026, we expect U.S. natural gas prices to increasingly converge with much higher overseas prices, and EQT will be among the biggest winners from this trend.

We continue recommending investors buy EQT (EQT).

DFH Wins No Matter Which Way Home Prices Move

Next, let's move on to the housing market, which remains in a persistent supply deficit, with only 1.04 million homes on the market for sale in April. This represents just 2.9 months of supply, or roughly half of the 6 months of supply typically considered to be a balanced market.

The U.S. housing shortage provides the key long-term tailwind for our recent recommendation of land-light homebuilder **Dream Finders Homes (DFH)**.

Dream Finders Homes (DFH), **noted for building business with "other people's money"**, announced Q1 results on May 4, reporting a 16% increase in homebuilding revenues versus Q1 2022. These gains were driven by the combination of an 11% increase in closings and a 5% increase in average selling prices.

Like many other home builders in today's housing market, DFH has boosted sales incentives (i.e., price concessions) to help consumers offset higher mortgage rates and higher home prices. Rising sales incentives in Q1 caused DFH's gross margins (i.e., gross profit as a percent of sales) to contract by 1.7 percentage points, falling from 18.7% to 17.0% over the past year.

While these incentives hurt profitability in Q1, they also helped DFH reduce its cancellation rate in Q1 to 20.9%, a substantial reduction from Q4's 32.1% cancellation rate.

Meanwhile, DFH is controlling costs where it can – including reducing its selling, general and administrative expenses from 9% of sales to 8% of sales over the past year. This helped DFH increase Q1 net income to $49 million, up 10% from $44 million in Q1 2022.

Looking ahead, homebuilders like DFH will benefit from inventory shortage… but suffer from high mortgage rates and high home prices. In the long run, we believe the supply deficit wins out to create a long-term structural tailwind for home builders across the board. And any respite in mortgage rates or home prices could help unleash pent-up demand for consumers struggling to find affordable homes.

One source of relief on home prices is coming from the declining price of lumber – the key commodity input for home builders. In the wake of the COVID-19 supply chain disruptions, lumber prices soared to all-time highs of $1,170 per 1,000 board feet by May 2021. Prices have since fallen by 70% to $344 per 1,000 board feet.

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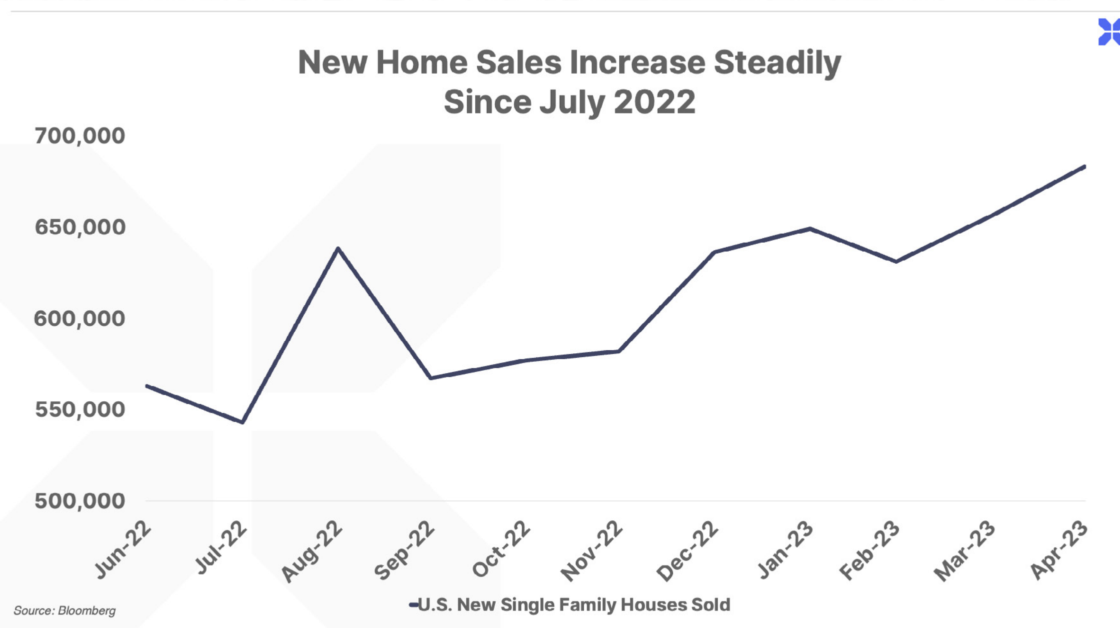
This has helped relieve pressure on home prices. Median U.S. home prices have fallen from a high of $495,000 in October 2022 to $421,000 in April 2023. Meanwhile, mortgage rates also peaked in October 2022 at 7.3%, reaching as low as 6.7% in March before rebounding recently to 7%.

The combination of lower mortgage rates and falling home prices has boosted new home sales, which bottomed at 543,000 in July 2022 and have since increased steadily to 683,000 in April 2023 – the highest level in over a year.



DFH's geographic exposure in some of the strongest housing markets, including Florida and Texas, provides an additional tailwind supporting new demand. This showed up in the company's strong net new orders for the quarter, which increased 31% from Q4.

The company's backlog remains robust, with 5,479 homes on order valued at a total of $2.5 billion. The majority of these homes are expected to be delivered in 2023, which will support the company's plans to sell 6,000 homes for 2023.

Looking ahead, DFH can win in multiple scenarios...

If home prices and mortgage rates decline further, more new buyers will enter the market, boosting demand for houses.

Conversely, if home prices and mortgage rates remain high, this also creates more demand for new homes. That's because the vast majority of home sales in the U.S. typically come from the sale of existing homes – where a homeowner lists their property for sale (instead of a new home from a home builder). But current

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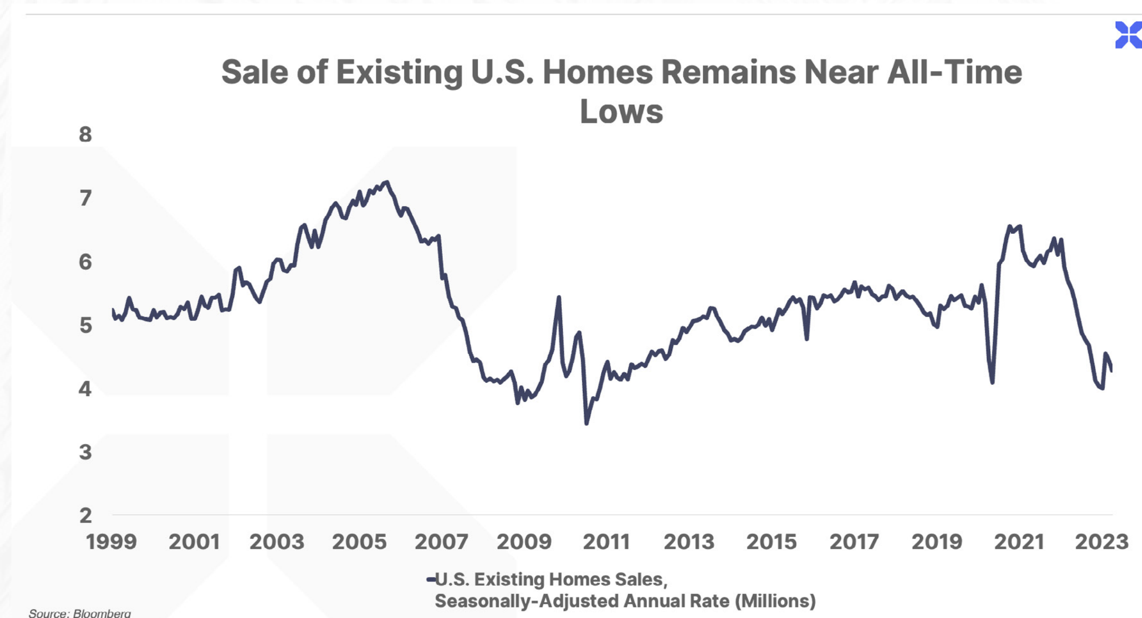
homeowners have little incentive to sell their homes today. That's because the vast majority of homeowners locked in mortgage rates at 3-4% over the last decade.

Selling would mean giving up their low-cost mortgage and taking out a new loan at today's higher rates. This explains why, even as new home sales have increased in recent months, the sale of existing U.S. homes remains depressed near all-time lows:



That means people who *do* want to buy new homes right now can't buy from current owners – so they're forced to purchase from builders like DFH instead.

While the housing market will likely continue facing short-term headwinds in 2023 - 2024, the housing shortage will likely persist for many years to come. And DFH is well positioned to provide much-needed supply.

If you already own shares, we recommend holding Dream Finders Homes (DFH). If you don't yet have a position, we recommend patience in waiting to buy on any pullback in the stock price to below $16 per share.

Mailbag

In *The Big Secret on Wall Stree*t mailbag, Porter answers letters from readers. He cannot offer individual investment advice, but can respond to general questions.

Please email us at **mailbag@porterandcompanyresearch.com** if you'd like to be featured in this segment. We'd love to hear from you!

Our first letter comes from J.M., who writes:

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"Your most recent publications now say the market is heading up! Does this mean the end of Distressed Debt investing for the present? or just a pause for a while? It seems I have been waiting to buy waiting for the big 30-50% drop that has been the on the horizon for several months. I need some guidance."

Porter's comment: Waiting a few months?!? My friend, the distressed debt bonanza that's coming will be a once-in-a-lifetime feeding frenzy. Patience my friend. These opportunities normally only emerge once or twice a decade. And the debt cycle that's coming, given the artificially low rates over the past decade and the number of corporate "zombies," should be the best opportunity in distressed debt, ever.

In regards to the bullish outlook of our new colleague, Scott Garliss, he sees the world differently. In a recent issue of **Porter & Co. Wealth Signals**, Garliss made a compelling argument for a short-term move higher in the S&P 500, based on the lopsided short positioning among speculative traders in the futures market.

S&P 500 Index Returns Following Extreme Futures Short Positioning

Date	3 Months	6 Months	12 Months	24 Months
Oct. 31, 2005	7%	9%	16%	33%
Apr. 28, 2006	-2%	6%	16%	11%
Aug. 31, 2007	1%	-9%	-11%	-27%
Oct. 31, 2011	5%	13%	15%	47%
Sept. 30, 2015	8%	9%	15%	37%
May 29, 2020	16%	21%	40%	41%
Average Return	6%	8%	15%	24%
Success Rate	83%	83%	83%	83%

Source: Bloomberg

Can the market go up because too many traders are short? Absolutely. Could the stock market go higher because earnings are stronger than expected? Absolutely.

On the other hand, we are seeing a slew of leading indicators that suggest a big economic slowdown is coming, like a persistent decline in manufacturing, and the sharpest contraction in M2 money supply since the 1930s. (Look at Scott's chart above and see what happened after a similar market dynamic occurred in 2007: stocks don't always go up, even when a lot of traders are short. Not if the economy

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implodes, like it did in 2008.)

What will happen? Beats me. Unlike Scott Garliss, who is running an aggressive trading portfolio for us (a very tough job), I'm not in the business of trying to predict the markets. All I have to do is be disciplined enough to buy great businesses when the market gives me the opportunity to do so at a fair price. That's a game I know I can win – as I think our track record demonstrates. And when it's time to buy a bunch of deeply discounted corporate debt, you'll know it.

That's why we continue to urge caution for long-term investors, as we believe the coming credit bust will create tremendous opportunities to buy world-class assets at fire sale prices, including stocks and corporate bonds.

Of course, the economy could weather through these headwinds. We could be wrong in the short term and stocks could rally before the economic fallout shows up in the financial markets – creating short-term opportunities like the ones that Scott will cover in *Wealth Signals.*

It's also worth noting that some legendary traders share Scott's current bullish view on the market, including Paul Tudor Jones and Steven Cohen. It's very possible markets will continue rallying in the coming months, before ultimately selling off... or that stocks have already reached their lows and it's all upside from here... in which case, we'll be happy to continue recommending the long-term investments in our current portfolio, while also searching for new opportunities in a rising market.

The bottom line is that we believe navigating today's market is ultimately a question of time frames, and of investment strategy. Traders and investors can both make money by taking different views and acting on different time frames. We also believe in fostering a healthy diversity of opinions across our analyst team to avoid falling prey to groupthink.

The next question comes from H.H., who writes:

> *"I was a long-time listener to the old Stansberry Research podcast back when you were on it every week. I really enjoyed that podcast and learned a lot from it. When it went behind the paywall I sort of lost track since I wasn't a member back then.*
>
> *It was your recent appearance on Frank Curzio's podcast where you told the sad story of what happened at Stansberry Research that led me to become a lifetime member with Porter & Co. I know you're very busy with the new company right now, but any chance you'll start a new podcast at some point? I think a lot of folks love the format and would enjoy hearing you opine on the state of the world and markets again."*

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Porter's Comment: Thank you, H.H. – we're happy to have you on board as a lifetime member.

You're certainly right, there is much to discuss in today's economic and social climate, and we're currently exploring the potential to set up a new podcast – stay tuned for future updates!

Porter & Co.

Stevenson, MD

P.S. If you'd like to learn more about the Porter & Co. team – all of whom are real humans, and many of whom have Twitter accounts – you can get acquainted with us **here** – or email our "Mailbag" address at any time:

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