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THE BIG SECRET ON WALL STREET

Better than Buffett, Plus a 16% Dividend

- 2023: The Biggest Legal Transfer of Wealth in History
- Why Next Year's Recession Will Shock Most Americans

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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Better Than Buffett, Plus A 16% Dividend

2023: The Biggest Legal Transfer of Wealth in History

Why Next Year's Recession Will Shock Most Americans

Someone had to call the chairman of the board, John Tuld, at 2:14 am.

It was the fall of 2008. Chairman Tuld had been expecting this call. He wasn't a fool. He knew that mortgage delinquencies were soaring, even though the prices on mortgage-backed securities hadn't been impacted – yet. He immediately flew in the company helicopter from the suburbs of Westchester to the roof of his bank on Wall Street, which was one of the largest and most important financial firms in the world.

Nothing in Tuld's 44 years of banking had prepared him for what was waiting in his conference room.

A junior analyst, Peter Sullivan, sat at a long conference table, flanked by about a dozen of the bank's top executives.

Tuld immediately got down to business.

> ***Tuld:*** *Mr. Sullivan, why don't you tell me what you think is going on here, and please speak as you might to a young child or a golden retriever..."*

> ***Sullivan:*** *Yes... Well as you probably know, over the last 36-40 months, the firm has begun packaging new mortgage-backed securities products that combine several different tranches of rating classification in one tradable security. This has been very profitable, as I imagine you noticed...*

> *But the key factor is these are essentially just mortgages, so that has allowed us to push the leverage considerably beyond what you might be willing, or allowed to do in any other circumstance, thereby pushing the risk profile without raising any red flags."*

Tuld, fearing that he knew where this was heading, wanted a number.

> ***Tuld:** And how far have we pushed that profile tonight, Mr. Sullivan?"*

> ***Sullivan:** We have pushed it to $1.215 trillion."*

As you might recognize, this is the script of the movie *Margin Call*. It is, by far, the best and most realistic dramatic rendering of the mortgage meltdown on Wall Street. It's modeled after real-life events at Lehman Brothers.

We'd recommend watching the movie. Not just for entertainment. This is all about to happen again over the next 12 to 36 months. But this time, as you'll see, the trigger will not be soaring default rates in mortgages. It will be soaring default rates in corporate bonds.

To jump ahead, what's about to happen is a completely unprecedented collapse in investment grade bonds. Much like mortgage-backed securities in the 2000s, Wall Street has long regarded investment grade bonds as a completely safe asset. The previous peak default rate, in the 1970s, was only 1%. Thus, much like what happened before with real estate, huge amounts of leverage have been piled on top of these assets.

The result will be stunning losses across the financial sector – unlike anything ever seen before in the market for corporate debt.

Imagine that you're Chairman Tuld. But instead of the fall of 2008, it's the fall of 2023. And instead of dealing with collapsing real estate prices and soaring mortgage defaults, you're dealing with collapsing equity values and soaring corporate bankruptcies.

> ***Tuld:** And Mr. Sullivan, what does your model say that means for us here?"*

Sullivan: *Well... sir... if those assets were to decline in value by just 25 percent, and remain on our books... well... that loss would be greater than the current market capitalization of this company."*

Tuld: *So what you're telling me, Mr. Sullivan, is that the music appears to be about to stop and we are going to be holding the biggest bag of stinking sh*t ever assembled in the history of capitalism?"*

Sullivan: *Well, sir, I'm not sure I'd put it that way, but let me clarify using your analogy: what this model shows is the music, so to speak, just slowing. If the music were to stop, as you put it, then this model would not be even close to that scenario. It would be considerably worse."*

An Economic Hurricane Is Coming

If there's one thing that there's plenty of in bond markets, it's jargon.

Just ignore it.

There are really only two things you have to understand about the crisis that's going to unfold next year.

First, the amount of money that American corporations have borrowed is unprecedented. As in, more debt than *ever before* in history.

And second: As with any other kind of credit market, the more people borrow, the lower the quality of the lending becomes. It's inevitable.

You can see this clearly in the data...

The big three credit ratings agencies, Moody's, Fitch and S&P Global, assign different grades to corporate bonds. These grades are based on key metrics like total debt and interest expense relative to profits.

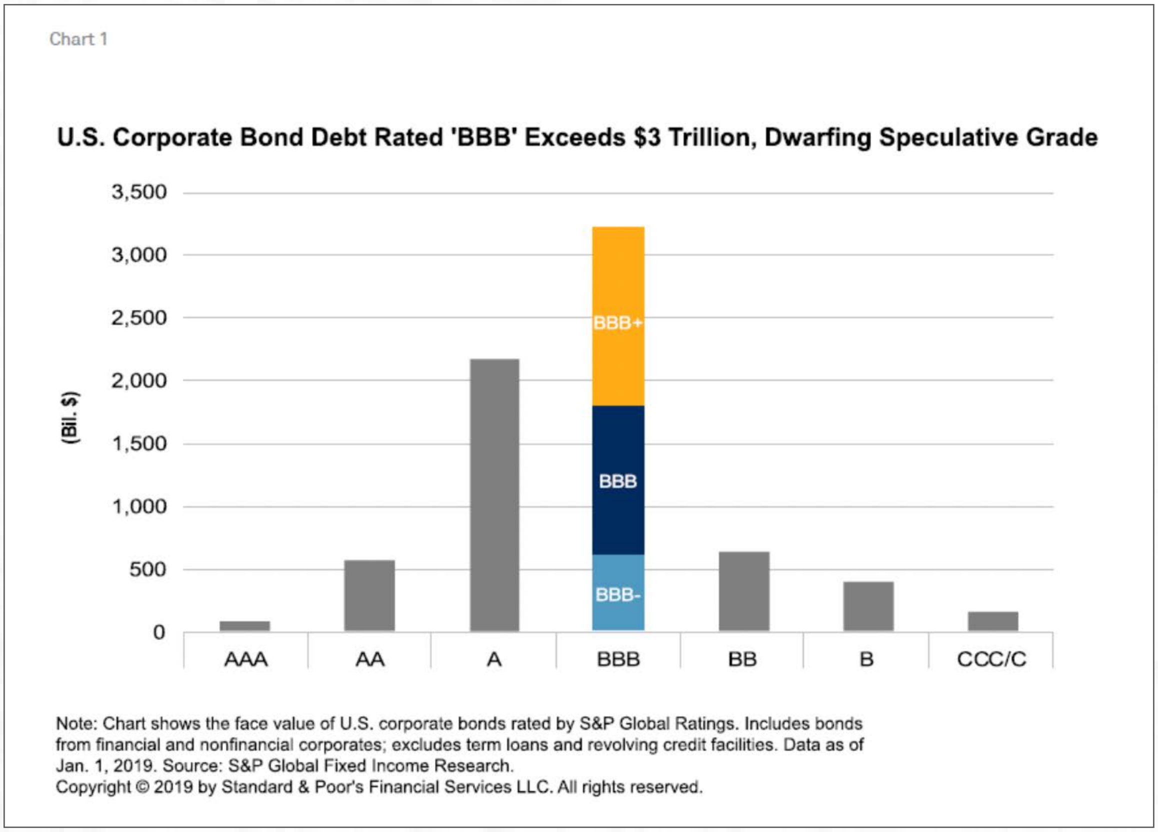
The highest-rated debt classification is AAA, reserved for the most pristine balance sheets. Companies with high debt loads and interest expenses relative to profits fall on the opposite end of the spectrum, with grades of CCC or below.

And in between these two extremes, there's a critical demarcation line between "investment grade" and "non-investment grade" bonds. The lowest rung on the ladder of investment grade bonds are "triple-B" (BBB)-rated bonds, as shown below:

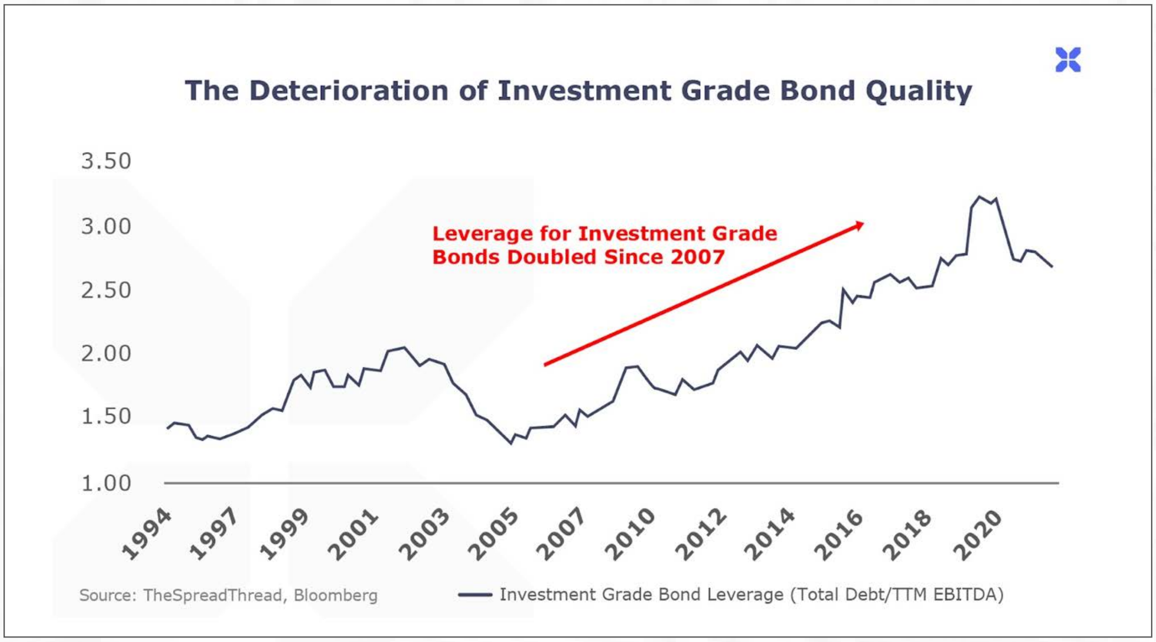
Moody's		S&P		Fitch		Equivalent to SVO Designations	Rating description	
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	NAIC		
Aaa	P-1	AAA	A-1+	AAA	F1+	1	Prime	Investment-grade
Aa1		AA+		AA+			High grade	
Aa2		AA		AA				
Aa3		AA−		AA−				
A1		A+	A-1	A+	F1		Upper medium grade	
A2		A		A				
A3	P-2	A−	A-2	A−	F2			
Baa1		BBB+		BBB+		2	Lower medium grade	
Baa2	P-3	BBB	A-3	BBB	F3			
Baa3		BBB−		BBB−				
Ba1	Not prime	BB+	B	BB+	B	3	Non-investment grade speculative	Non-investment grade AKA high-yield bonds AKA junk bonds
Ba2		BB		BB				
Ba3		BB−		BB−				
B1		B+		B+		4	Highly speculative	
B2		B		B				
B3		B−		B−				
Caa1		CCC+	C	CCC	C	5	Substantial risks	
Caa2		CCC					Extremely speculative	
Caa3		CCC−					Default imminent with little prospect for recovery	
Ca		CC				6		
		C						
C		D	/	DDD	/		In default	
/				DD				
				D				

The triple-B class of bonds was the single biggest beneficiary of the corporate credit bubble of the last decade. From 2007 through 2021, the value of triple-B bonds in the U.S. surged from roughly $700 billion, to a record high of over $3 trillion today.

This explosion in issuance made triple-B debt the single biggest segment of the corporate bond market, which is now a record 58% of the investment grade universe:



Meanwhile, the quality of investment grade deteriorated as ratings agencies became more lax in providing their stamp of approval over the last decade. The chart below shows how the leverage ratios of the investment grade debt universe roughly doubled from 1.5 times in 2007 to 3.0 times today:



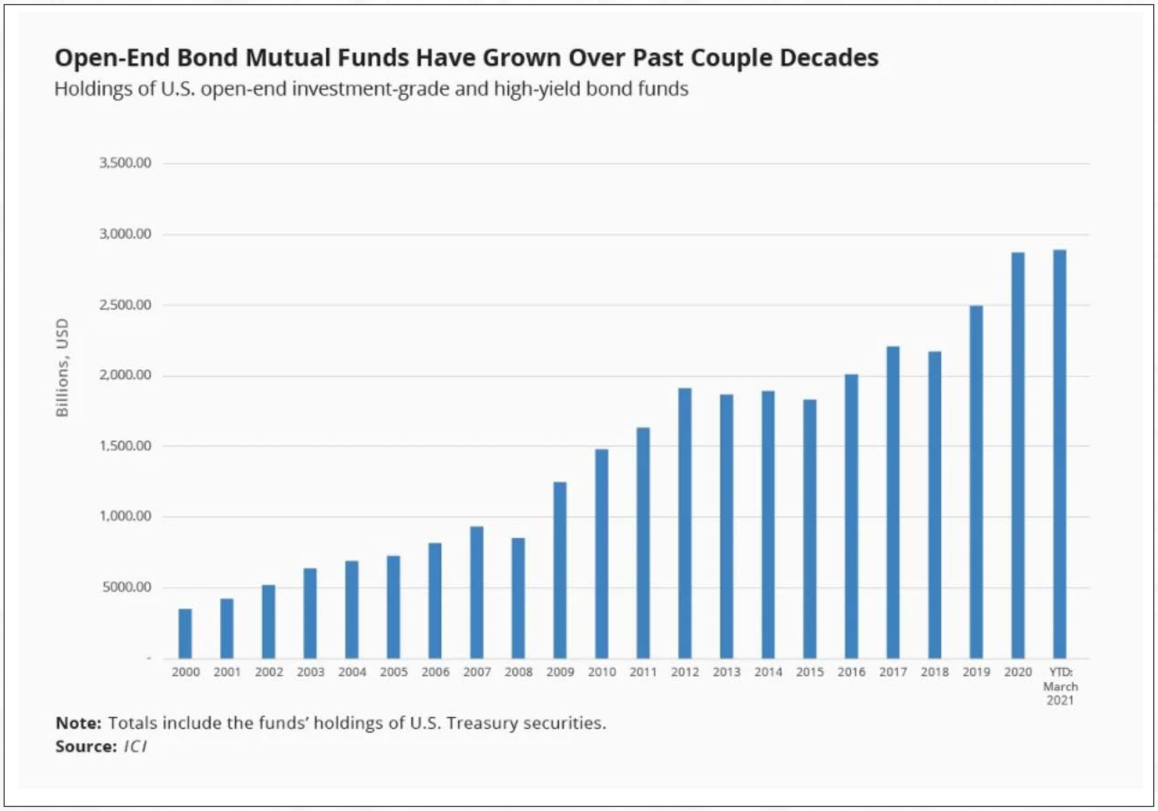
The explosive growth, and deteriorating quality, of the "investment grade" bond universe will play a major role in the coming corporate debt crisis. The reason is because a record volume of today's investment grade bonds will soon get downgraded into non-investment status… and that's a big problem for millions of American retirement accounts.

If you have a fixed income allocation in your 401(k) or IRA, chances are that you might own some of these bonds.

The Ticking Time Bomb in Americans' Retirement Portfolios

By dropping rates to zero over the last decade, the Federal Reserve – and central banks around the world – pushed investors everywhere to reach for yield. Retirees were hit especially hard, as the Fed removed the ability to earn safe yields from the traditional retirement income vehicle – Treasuries.

So, countless retirees and other yield-starved investors found an alternative source of yield in corporate debt. That's how the volume of corporate bonds held in mutual funds more than tripled since the Fed dropped rates to zero in 2009:



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Likewise, the same reach for yield fueled an explosion in assets among corporate bond exchange traded funds (ETFs).

As regulators clamped down on reckless real estate lending in the wake of 2008, the credit created over the last decade migrated. Its new home was corporate bonds. And instead of going through the banks, this credit was funneled through alternative avenues, like mutual funds and ETFs.

The vast majority of mutual funds and ETFs that own corporate bonds are passively managed. That means there's no human investment manager calling the shots. Instead, the buy and sell decisions are on autopilot, dictated by a series of rules. One of these rules says that if a bond loses its investment grade rating it must be sold. No debate, no discussion, no questions asked.

And bond ratings are dynamic. A bond rated "investment grade" today could easily get downgraded to "non-investment grade" tomorrow.

What could trigger such a downgrade? A decline in earnings, as a result of the recession, is one trigger. Another trigger is rising interest rates. In each case, the debt burden and interest expense relative to earnings deteriorates, exceeding the threshold for an investment grade rating.

A one-two punch of a sharp recession, caused by higher interest rates, would be the ultimate disaster scenario. And that's precisely the scenario we see coming...

Given the massive growth in investment grade bonds sitting at the lowest rung of the ratings ladder, this would trigger an avalanche of downgrades into non-investment grade status.

And that means one thing – fire sales. Billions of dollars in sell orders coming from every passively managed mutual fund and ETF that owns investment grade corporate bonds.

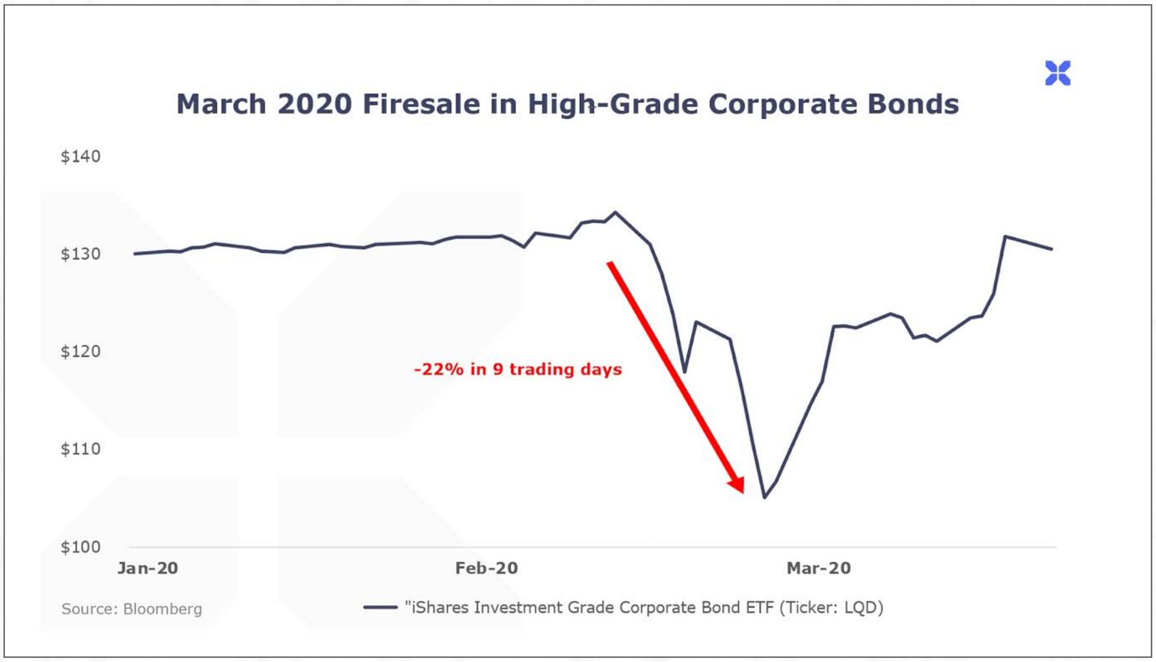
Now, a fire sale in the highly-liquid stock market is one thing. But it's a whole different story in the corporate bond market, where the average corporate bond trades about once a month.

The problem is, the mutual funds and ETFs holding these illiquid bonds create the illusion of liquidity. That's because these mutual funds and ETFs are set up to allow for unlimited volumes of daily trading by individual investors. But the underlying instruments in these funds – corporate bonds – do not have sufficient liquidity to process large sell orders. This liquidity mismatch is a ticking time bomb waiting to go off if investors ever lose faith in their bond holdings and rush for the exits. Or, if a rash of downgrades forces the fund to dump bonds due to ratings downgrades.

Bank of England Governor Mark Carney once explained this fatal flaw…

> *"These funds are built on a lie, which is that you can have daily liquidity, and that for assets that fundamentally aren't liquid."*

We had a preview of what the coming fire sale in corporate bonds will look like back in March 2020. The high-grade corporate bond exchange traded fund (ETF) collapsed by 22% in nine trading days:

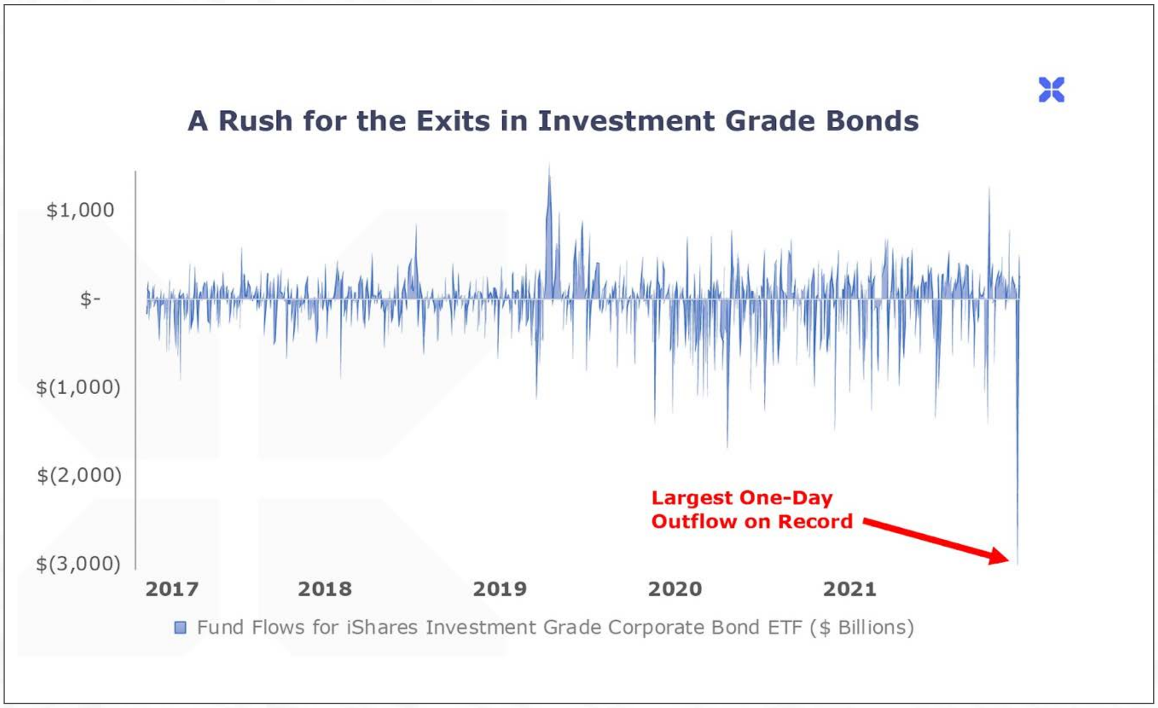


The situation became so dire that for the first time ever, the Fed stepped in to buy corporate bonds. But this merely inflated the bubble further. After the Fed's intervention, U.S. corporations sold a record $300 billion in debt in April 2020.

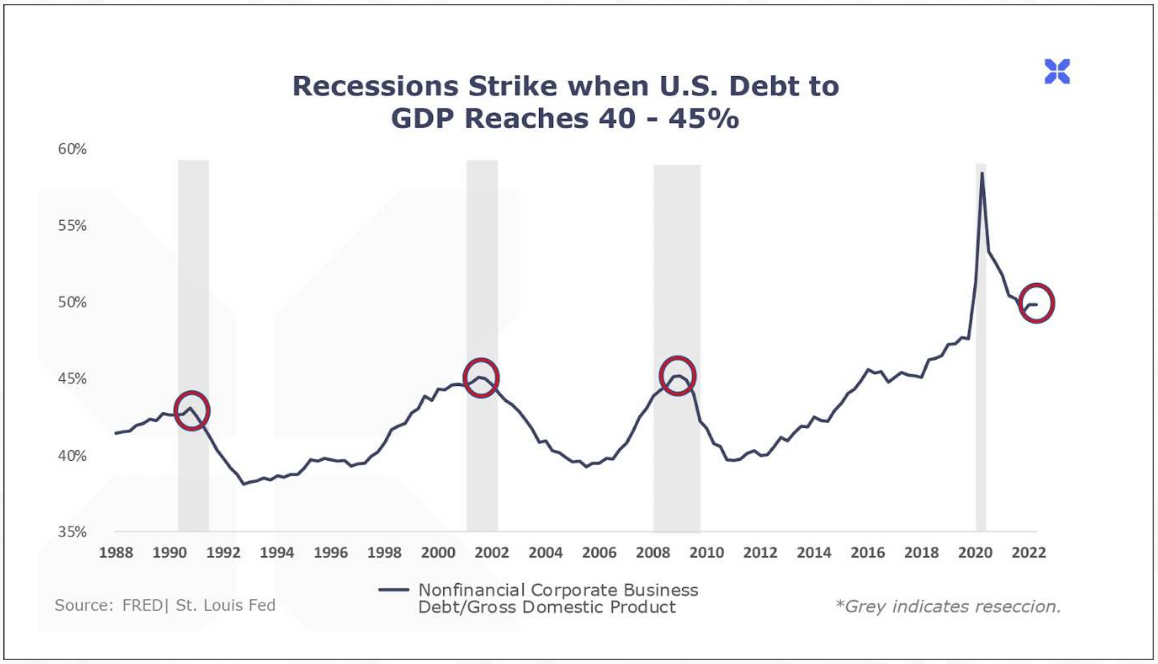
With inflation running out of control, this kind of intervention is now off the table. The coming fire sale will make March 2020 look like a picnic. The smart money knows what's coming, and that's why they're selling first and asking questions later.

Where to Be When the Lights Go Out

Last Monday, more than $3 billion exited the largest investment grade corporate bond ETF (LQD). This was the single biggest one-day sale since the fund was launched in 2002, representing nearly 10% of the $36 billion in assets:



This is what the beginning of a fire sale looks like. And it's right on cue with historic precedent. Over the last three decades, any time corporate debt reached 40 - 45% of GDP, a default cycle was triggered. Today, corporate debt to GDP is at an alarming 50% of GDP, ensuring one of the largest default cycles ever lies just ahead:



There will be a lot of carnage when the corporate debt bubble unwinds. And as with any crisis, it will also unleash incredible opportunities.

The same kind of opportunity that struck during the 2008 Financial Crisis, when high-quality stocks were crushed along with everything else. When today's corporate debt bubble unravels, waves of forced selling will punish bond prices across the board.

Of course, just because a bond loses its investment grade rating, doesn't mean that it won't get repaid. Even during bankruptcy, the average corporate bond gets repaid to the tune of approximately 40 cents on the dollar. In the world of debt investing, "there are no bad assets, just bad prices," to quote legendary bond investor Howard Marks.

During the coming corporate bond fire sale, prices will plunge to levels far below any reasonable estimate of fair value. For those who can separate the wheat from the chaff, fortunes will be made.

In the meantime, there's one publicly traded investment vehicle that provides investors with access to the best-distressed debt management team in the business. This vehicle currently pays out a safe 16% yield, and offers upside exposure to the large volume of distressed debt opportunities we see coming in the months ahead.

Why Carl Icahn Is a Better Investor than Warren Buffett

On June 1, 1989 Carl Icahn sold 42.3 million shares of Texaco for $49.

It was, and still is, the largest single trade in the history of the New York Stock Exchange.

Icahn established his Texaco position in the aftermath of 1987's "Black Monday." An Australian investor, Robert Holmes, was in financial distress. Facing margin calls because of the stock market crash, Holmes had to sell a huge block of Texaco. Icahn bought half of Holmes's shares for $33. But that's not all.

One of the reasons Icahn's returns are extraordinary is that he's consistently able to get terms that ordinary investors can't get.

Although Icahn bought only half of Holmes's shares, he negotiated for 100% of Holmes's voting rights, plus a free option to buy the other half of his shares at the same price for a year. The value of that option, given Texaco's dire situation at the time, was extraordinary. The option explains most of the extraordinary value Icahn would later realize (although Icahn also bought another 12 million shares in the open market), becoming Texaco's largest shareholder.

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Texaco was distressed because of a crazy Texas lawsuit. A jury of yokels awarded motor oil company Pennzoil an incredible $12 billion judgment, due to a dispute over Pennzoil's failed bid for Getty Oil. That was despite the fact that Getty – the subject of the lawsuit – was just a $3 billion company. The lawsuit came just after Icahn's successful bid for Texaco, and threatened to push Texaco into bankruptcy.

Icahn knew, sooner or later, the legal judgment would be overturned on appeal. His option allowed him to wait and see how the legal problems were resolved. Texaco eventually settled the matter for $3 billion, which sent its shares from the $20s to $50s.

In total, including special dividends, Icahn made $524 million on this investment in less than two years.

How Icahn "Cheats"

Icahn, like Warren Buffett, is a great investor. But, unlike Buffett, Icahn isn't interested in a "fair game." When Icahn takes a position, he finds a way to "step on the scale" in his favor. The result of both great investing and being "activist" – thereby gaining an unusual advantage – produces truly extraordinary returns over time. Icahn's results are far better than Buffett's.

Icahn's hedge fund returned 31% annually between 1968 and 2011. True, Berkshire Hathaway isn't leveraged like a hedge fund. But long-term studies of Icahn's major equity positions (when he takes more than a 5% stake, his investment must be disclosed via a 13D filing) reveal annual returns in excess of 26%, which are higher than Buffett's long-term average of just over 20%.

More recently, the differences in performance have become greater, as Buffett's performance coming out of the Global Financial Crisis (GFC) wasn't very good. Buffett began to underperform the S&P in the decade after the GFC because of many subpar investments like IBM, GE, and GM. More recently, Buffett's performance has rebounded strongly, due mainly to a huge (40% of the portfolio) investment in Apple initiated in 2016.Don't forget, Icahn put $2 billion into Apple in 2014.)

And most investors simply aren't aware of how many incredible investments Icahn makes because he buys a lot of private assets. A great example? Icahn uses Las Vegas as a personal piggy bank.

In 1997 Icahn bought the Stratosphere casino in Las Vegas out of bankruptcy, and then proceeded to buy vacant land around the tower, in addition to two other, smaller casinos. His Vegas bet totaled $300 million – but it couldn't be tracked on the stock market.

Ten years later, Vegas had boomed. MGM Resorts was spending $10 billion to build "City Center" – the largest privately funded real estate development in U.S. history.

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As the "hot money" flowed in, Icahn stepped aside, selling his Vegas assets to the Goldman Sachs' Whitehall Street Real Estate Fund for $1.3 billion. The key to the deal was the 17 acres of vacant land, which had soared in price and which the fund thought could be flipped. Altogether, Icahn made $1 billion in Vegas in a decade.

But that's not the best part of the story.

Within a year of Icahn's 2007 sale, the GFC hit and Vegas real estate prices crashed. Goldman's real estate fund, which had borrowed heavily, saw virtually all its equity wiped out by 2010. It would eventually sell the Stratosphere assets at a half-a-billion-dollar loss.

Meanwhile, Jeffrey Soffer, the Florida developer who purchased and refurbished Miami Beach's grand dame resort, The Fontainebleau, was building a new Fontainebleau in Las Vegas. Construction started in 2007. The building was "topped" in November 2008. It was the worst time imaginable to try to complete a new casino in Vegas, when vacancies had soared and about half the town was laid off. Conditions were so bad that in 2009, Bank of America wouldn't release the final $800 million in funding. The hotel, on 24.5 acres directly across from the Las Vegas Convention Center, was a half-completed eyesore.

In June 2009, Fontainebleau Las Vegas filed for Chapter 11 bankruptcy. More than $2 billion had been lost on the project, making it the worst real estate investment of all time.

And who was waiting at the courthouse? There was only one qualified bid for the Las Vegas Fontainebleau – a $150 million offer by Carl Icahn.

In 2007, during the boom, Las Vegas strip real estate was changing hands at $34 million an acre. Carl Icahn bought the Fontainebleau for $6 million an acre and got a $2 billion structure (4,000 hotel rooms, 100,000 square feet of casino space, 180,000 square feet of retail space, and 400,000 square feet of convention space) for free.

What did Icahn do with this enormous property? He didn't spend a dime on it. He auctioned off every single piece of furniture and equipment on the site, including carpeting, netting around $5 million. In 2015 the city finally made him put at least a cloth covering over the bottom two floors, which were still mostly exposed concrete. Then, in 2016, he sold the property, unfinished, for $650 million, or more than four times what he paid.

Gurufocus.com studied Buffett's versus Icahn's returns for the 20-year period between 2000 and 2020, and found Icahn's investments have produced a total return of 1,980% compared to 545% for Berkshire Hathaway. Icahn's returns are hard to track because for many years he ran a private hedge fund in addition to his public holding company, Icahn Enterprises.

But… in 2011 Icahn shut down his hedge fund, and now conducts most of his market operations through his publicly traded holding company, **Icahn Enterprises (NYSE: IEP, $50)**, of which he controls 87%.

Who Will Make the Most Over the Next Cycle? Icahn

We believe Icahn, mostly through this holding company, Icahn Enterprises, will be the very best investor to follow (and invest with) through the coming corporate debt "super cycle." We're calling the coming market carnage in corporate bonds The Greatest Legal Transfer of Wealth in History.

In our opinion, there has never been a better distressed debt investor, ever, than Carl Icahn.

There's one other very important issue: Icahn has complete integrity. He always treats other investors fairly and honestly. Sure, he's extremely tough. And he finds clever ways to game the system (see his Vegas adventure). But he doesn't cheat anyone, even when, technically, he could.

For example, during the GFC, many investors in his hedge fund needed their money back because of other financial pressures. The rules of his fund stated that redemptions would only occur through a 3-year process. That was to make sure that the fund had sufficient capital and enough "staying power" to do things like buy relatively illiquid real estate and other distressed assets. But Icahn met every redemption demand, in full, with his own capital.

If you haven't ever heard him talk about investing or about his philosophy, I'd urge you to watch his conversation at the **2015 DealBook conference**. Some of the core ideas discussed remain germane today – like the disconnect between the underlying bond market illiquidity and the daily liquidity promised by corporate bond ETFs.

Icahn has gotten a bad rap over the years in the media because he's very hard on company management. He stands up for capital. And that makes him the enemy of labor. He is also a Trump supporter, which of course makes him a target for the media. But I would urge you to listen to him talk, not just about investment strategies, but about right and wrong. Icahn continues to be personally offended by management teams that are cavalier with investors' assets. And it's that personal animosity that makes him such an incredible investor.

Additional evidence of Icahn's unusual approach is his dividend policy. In part because there haven't been many (or any) distressed opportunities for so long (when capital is free because of manipulated interest rates, it's hard for anything to end up in distress), Icahn began paying a big cash dividend to all of his investors in 2013. He lifted the dividend from $.09 to $1.00 per quarter in 2013. Then to

$1.25 in 2014. Then to $1.50 in 2015. Then to $1.75 in 2018. And finally to $2.00 per quarter in 2019, where it remains today.

That means, at $50 per share, Icahn's $8 per share in dividends are equal to a yield of 16%. In other words, Icahn is willing to pay you 16% a year to invest with him, while he's waiting for distressed opportunities to emerge.

Further bolstering shareholder value is the fact that Icahn has been slowly taking this company private. But he treats every investor fairly. Every quarter each partner (IEP is a partnership, so shareholders have to deal with a K-1 tax form every year) can elect whether or not to receive the $2.00 dividend in cash or in stock. And every quarter, Icahn personally takes stock – which is a great option.

It's likely that when the markets change and opportunities emerge, Icahn will reduce or even suspend the dividend to retain cash to put into distressed investments. (We can't wait to see what he buys in Vegas this time!)

Also, be aware that there's a lot of controversy about these "dividends," which are actually distributions because it's a partnership.

There has been some question about how long IEP can afford to pay such distributions because as a holding company it has very irregular earnings. Usually, the assets it buys are distressed, like its Pep Boys auto parts business – which typically don't generate much in the way of earnings until they are fixed and sold. Icahn's typical holding period for these kinds of "fix 'em up" opportunities is 7-9 years.

Critics warn that companies run by dishonest managers (like GE after Jack Welch left) often use acquisitions and assets sales to try and fool investors, where every asset sale is applied to earnings and every loss is hidden as a "one-time, non-recurring charge."

Icahn isn't like that. Not that he never takes a loss, but the overwhelming majority of his investments are big wins. And either way, he currently has plenty of capital to continue paying the dividend. IEP holds $1.7 billion in cash on its balance sheet, or nearly 30% of its book value. Icahn has plenty of "dry powder" and can raise billions more thanks to his reputation.

And... finally...there's one other thing that owning Icahn will do for investors that's not commonly appreciated: IEP is an excellent hedge. Currently the company's investment funds ($4.4 billion) have a net short notional exposure equal to 54% of the funds. Short selling is a very difficult game, but Icahn is great at it.

There is, of course, no sure thing in finance or investing. But the surest thing we can imagine is that Icahn is going to make an absolute killing over the next 24-36 months as, for the first time since the GFC, he begins to accumulate billions of distressed assets for pennies on the dollar. If you want to be on the right side of the Greatest Legal Transfer of Wealth in History, we strongly recommend buying a "full" position of Icahn Enterprises **(IEP)**.

As an investor in IEP, you'll get paid 16% to wait and watch the carnage in a well-hedged holding company, managed by Carl Icahn. Is there a better opportunity in all of finance today?

We doubt it.

Action to take: Icahn Enterprises **(Nasdaq: IEP)** is no longer an active recommendation. We recorded a 51% loss on the position in the model portfolio of *The Big Secret on Wall Street*.

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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**. You can reach me (Porter) personally via:

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