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THE BIG SECRET ON WALL STREET

The DIY Business With 21% Returns

- A Booming Chain for Pros and Fixer-Uppers
- 90% of the Population Lives Within 10 Miles of a Store

FROM THE DESK OF PORTER STANSBERRY

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The DIY Business With 21% Returns

A Booming Chain for Pros and Fixer-Uppers

90% of the Population Lives Within 10 Miles of a Store

On May 22, 1990, Rosalind Webb rode the No. 48 bus downtown to work for the last time.

Rosalind didn't know it, but she was about to be fired from the shipping department of the Bonwit Teller department store in Philadelphia, where she had worked faithfully for the past 30 years.

Later that Tuesday morning, she'd climb back on the homeward bus with no job, no pension, and no health insurance (unless she decided to pay $181 out of pocket every month).

> *"All those years I had health insurance and didn't need it," she later told the Philadelphia Inquirer. "Now I need it and don't have it."*

It wasn't Rosalind's fault that her long-standing job – and her retirement – vaporized. Her employer, the Bonwit Teller department store – along with several other venerable chains like B. Altman & Co. and Sakowitz – was owned by L.J. Hooker, a company that was filing for a hefty $1.2 billion bankruptcy.

And as part of its Chapter 11 reorganization, Hooker had brought in a cost-cutting guru who went by Ming the Merciless.

Ming was the mustachioed villain from the Flash Gordon television series – and also the chosen nickname of "reorganization expert" Sanford C. Sigoloff, whose crisis-management firm guided troubled companies through bankruptcies in an effort to turn them around.

In addition to his TV-baddie alias, Sigoloff also answered to "The Skillful Scalpel" and "Mr. Chapter 11." And he was yelling "You're fired!" years before Donald Trump made that catchphrase popular on The Apprentice.

Bankruptcy was big business from the late 1970s to the late '80s – a decade that produced the largest crop of filings since the Great Depression. A long-overdue update to the U.S. Bankruptcy Code in 1978 had made it easier for companies to file and reorganize – and potentially, restart instead of disintegrating.

Along with the billion-dollar bankruptcies came $500-an-hour consultants... like Sigoloff, who, in true movie-villain style, carried around a 260-page cost-cutting manual that workers dubbed the "Infamous Black Book" (IBB for short).

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Sigoloff's money-saving strategy was simple: Fire everyone. Just a few months after taking over the reins at L.J. Hooker and assuring employees that "Paychecks will be issued at the same time as if no [bankruptcy] proceeding had been filed"… Sigoloff terminated 12,000 employees at the company's department stores, leaving just 62 people on staff nationwide.

Sigoloff's damn-the-employees, fix-the-company, line-my-wallet strategy worked beautifully… for the most part.

Throughout the '70s and '80s, he resuscitated a series of high-profile, near-defunct companies, including movie studio Republic Corporation, manufacturer Wickes Companies, and conglomerate Gulf and Western Industries.

In the process, he made a good living. As the *Philadelphia Inquirer* **reported** in a 1991 expose, during just one year of the 1980s "bankruptcy boom" Sigoloff's small firm took home $6.5 million in consultant fees.

While Rosalind Webb and her former coworkers filed for unemployment, Merciless Ming and his associates charged exorbitant prices for completing the tiniest of tasks. Some of Sigoloff's line items included $1,500 for making phone calls, $450 for unpacking a box of files, and $3,000 for a day of "reviewing the master calendar."

But every bad guy gets a taste of his own medicine sooner or later…

As elderly Rosalind Webb, cheated out of her well-deserved retirement, could have told Sanford Sigoloff… it's not smart to fire great employees just so you'll have room to bill $500,000 for "time the associates spent in planes."

It was during the 1975 reorganization for retail conglomerate Daylin, Inc. that Ming the Merciless made his big mistake.

Wielding the Infamous Black Book, Mr. Chapter 11 chewed his way through Daylin personnel, firing half of the struggling company's 16,000 employees. But he didn't stop with the underperforming divisions. In 1978, he also canned the CEO and CFO of one of Daylin's few profitable chains, the Handy Dan hardware store.

Why fix something that's not broken? (Especially when dealing with hardware salesmen?) Sigoloff claimed that the two executives had authorized an improper anti-union fund, which they denied.

But more likely, he just saw two $400,000 salaries that could be slashed… and an extra $800,000 that could be diverted into consultant fees.

So… "You're fired," said Ming the Merciless.

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The two newly unemployed men walked out of the hardware store and, two months later, started what has become a capital efficient, world-dominating business that's now worth $295 billion. That's the business we're recommending in this issue.

None of Sanford Sigoloff's "successful" turnarounds remotely approached the market cap of this American mainstay. And when he developed Alzheimer's years later – this story is probably one of the last things he forgot.

Taking Home Improvement to a New Level

After getting laid off from Handy Dan's, Bernie Marcus and Arthur Blank met up at a coffee shop to sketch out their new vision for home-improvement stores. The former hardware-store executives wanted to offer consumers an unmatched array of products for one-stop shopping. Scribbling on a restaurant napkin, they created the blueprint for the word's first home-improvement superstore.

They called it **The Home Depot (NYSE: HD)**.

In June 1979, the first two Home Depot stores were launched in Atlanta, Georgia. Each location stocked 25,000 products in a massive 60,000 square feet of retail space, much larger than any other hardware stores at the time.

Home Depot's unmatched product selection was amplified by world-class customer service.

As avid DIY (do-it-yourself) enthusiasts themselves, Marcus and Blank saw firsthand the shortcomings of traditional home-improvement stores. Salespeople did little more than help customers find items on the shelves. But if a customer had never fixed a leaky pipe before, simply pointing them to the plumbing section was of little value.

Marcus and Blank built their sales staff to deliver an extra level of customer experience that could offer guidance, education, and reassurance. Instead of hiring employees with retail backgrounds, they paid up for highly trained tradespeople, including plumbers, electricians, and construction workers. As the company history explains, the sales staff had to be able to "walk customers at every skill level through most any home repair or improvement."

Marcus's key insight was that he knew he wasn't in the business of just selling home-improvement products. "We're in the people business," he preached constantly to his staff.

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Marcus also recognized the value of treating employees well. Home Depot became known for paying some of the highest wages in the industry, and providing a generous benefits program. This included healthcare, retirement plans, and an employee stock-ownership program. Marcus distilled his basic philosophy for running the business as:

> *"Take care of the associates; they will take care of the customers, and everything else will take care of itself."*

Of course, any executive can come up with an empty platitude. The secret to the success of Home Depot was that Marcus and Blank led from the front lines.

In the first few months after opening the first Home Depot stores in 1979, Marcus spent most of his time staking out the parking lot and conducting impromptu customer surveys. He asked those who left empty handed why they didn't make a purchase. The most common reason was the store didn't have the items they were looking for. Taking down customer names, Marcus would track down the products – even if it meant buying them from a competing store – and personally delivered the items to their homes.

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As Marcus explained in *Built From Scratch*, the book about the company he co-wrote with Blank:

> *"Arthur and I go into the stores alone, and walk around, talking to customers and associates on the sales floor, learning what's really important to The Home Depot. I love being there because that's where the real action is, not in my office."*

This laser focus on customer satisfaction paid off, as Home Depot enjoyed robust demand at its first two stores. The company expanded to four locations in Atlanta by 1981, and went public that same year, which set the stage for a rapid expansion over the next two decades.

America's Largest Home-Improvement Chain

By 1990, Home Depot had grown to nearly 200 locations across 15 states, generating $2.75 billion in annual sales. This made it the largest home-improvement store in the United States, surpassing the former leader Lowe's Home Improvement, which had a more than a 50-year head start.

The success came from following the same basic playbook of offering an unmatched product selection paired with world-class customer service. By the 1990s, the average Home Depot store had grown from 60,000 to roughly 100,000 square feet, with an additional 10,000 to 20,000 square feet of outdoor lawn and garden products. The company also continued creating new ways to better serve customers.

This included the introduction of DIY clinics and workshops that offered the first-of-its-kind training programs for customers. Weekend warriors could take an afternoon course to learn the basics of installing doors, hanging light fixtures, and fixing leaky pipes. For those too busy to take an afternoon course, Home Depot published a 480-page book called *Home Improvement 1-2-3*, which offered a comprehensive manual on a range of advanced DIY projects.

The company also introduced Expo centers, staffed by professional designers with full showrooms that displayed interior products like hardwood floors, area rugs, and kitchen tiles from around the world.

By 1994, Home Depot expanded outside the U.S. with the purchase of Aikenhead's, Canada's largest home-improvement chain with 75% market share there. It later expanded into Mexico and China, before ultimately exiting the Chinese market to remain focused purely on North America.

Home Depot entered the new millennium riding high. In 2000, sales reached $38 billion – more than twice the size of its next closest competitor, Lowe's. Since its 1981 IPO, Home Depot shares had delivered an incredible 51.5% compounded annual return.

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Co-founders Bernie Marcus and Arthur Blank had become billionaires – and set the stage for their retirement in the early 2000s. They passed the reins on to a former General Electric executive Robert Nardelli, who became company CEO from 2000 to 2007.

But it turned out to be a bad pick for the top job. Nardelli's management style was a stark departure from the key principles that had made Home Depot great, and things quickly went south under his tenure.

The Bean Counters Take Over

Robert Nardelli represented everything that Bernie Marcus and Arthur Blank were not. Marcus and Blank ran the company from the bottom up. They took care of the store associates, which ensured great customer service, and everything else took care of itself – the philosophy that guided their early success.

Nardelli, on the other hand, ran the business from the top down. The former GE executive approached the job with a spreadsheet mindset. He believed that one retail employee was just as good as another – paying up for highly trained staff was an unnecessary expense, he said. So he dramatically cut back on employee compensation, even as he cashed in on his own $123.7 million, five-year pay package – more reminiscent of Sanford C. Sigoloff than founders Marcus and Blank.

This created a broad sense of resentment among front-line workers. As one anonymous Home Depot employee explained in a **2007 *New York Times* article:**

> *"All of us felt that the raises we should have gotten were going into Nardelli's pocket."*

Feeling underpaid and underappreciated, Home Depot suffered a talent drain. Losing its best floor employees translated into a degradation of the customer experience, as the same employee told the *Times*:

> *"I used to be able to find an expert to answer any customer's questions... But he [Nardelli] dumbed down the workforce, and the customer service has gone way down."*

Many of Home Depot's most valued employees left for competitors, like Lowe's. And so did the customers. From 2000 to 2006 – during Nardelli's tenure – Lowe's sales growth outpaced Home Depot's by more than 50%.

Nardelli attempted to overcome the sluggish sales by opening new locations. Home Depot's store count soared from 875 in 2000 to 2,100 by 2006.

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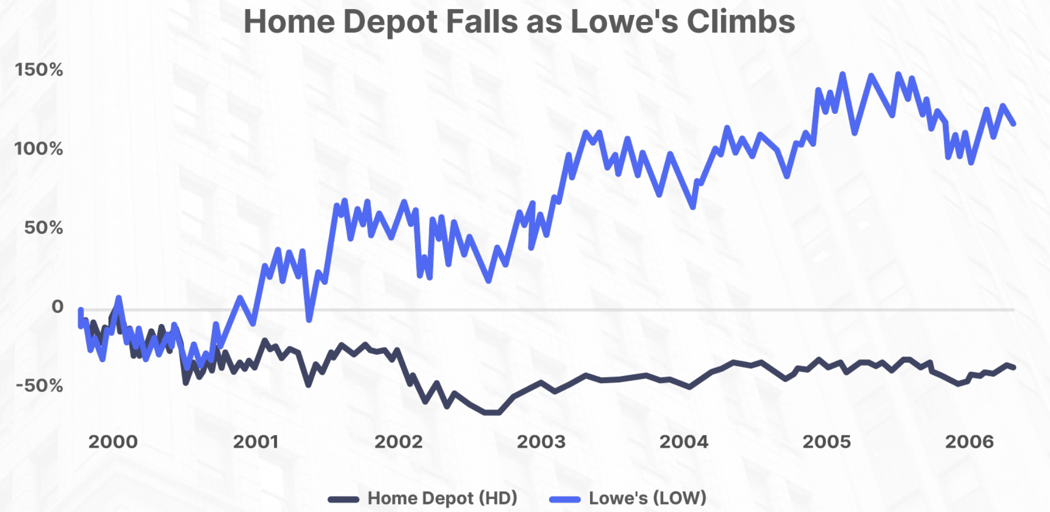
But customers weren't shifting to Lowe's because of a lack of stores. It was poor customer service that sent them away. Nardelli's aggressive growth in new stores merely compounded the problem of falling demand. This led to an oversaturation of Home Depot stores, and new locations cannibalized sales from existing ones.

This was reflected in a key company financial metric. Home Depot's same-store sales ("SSS") plunged. SSS measures the growth in sales from a retailer's existing store base and factors out growth that come from opening new stores.

When Nardelli took over Home Depot in 2000, the company was consistently generating 7% to 10% SSS growth. By 2002, within just two years of Nardelli taking over operations, SSS growth plunged to 0%. That same year, Lowe's began an eight-year stretch of outpacing Home Depot in SSS growth.

With Home Depot losing market share to the competition, its formerly high-flying stock price cratered. From 2000 to 2006, Home Depot shares fell 42%, compared with a 109% gain in Lowe's shares.



Source: Bloomberg

In January 2007, Frank Blake replaced Nardelli as Home Depot's CEO. Blake had previously served as the company's executive vice president for corporate operations, and he ushered in a return to the founders' roots.

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Blake started with an immediate change in tone – accepting a much smaller pay package than his predecessor. Instead of Nardelli's compensation structure that rewarded him regardless of how he ran the business, Blake's payout was linked to company success. He also realigned the strategic focus back on the customer experience, starting by taking care of front-line workers. Blake implemented salary increases and new benefits programs that achieved the desired effect – attracting and retaining top talent.

But Blake's biggest contribution by far came from transforming Home Depot's biggest weakness into an incredible asset.

From Average Joes to Building Pros

When Blake took over in 2007, Home Depot's massive 2,100 store footprint was 55% larger than Lowe's. This left Home Depot with a bloated store base relative to the demand for its key market – serving DIY home-improvement customers.

But Blake saw an opportunity to leverage Home Depot's unmatched number of stores into an advantage for serving the market for builders and contractors.

For these professionals on the job site, time is money. For example, **Sherwin-Williams** became the go-to choice for professional painters because of its unmatched store footprint. By having the industry's most dense concentration of retail outlets, America's leading paint brand saves professional painters valuable time by minimizing the distance traveled in their frequent trips back and forth during a project.

The same dynamic applies to building contractors. When a multimillion-dollar construction project is underway, a broken table saw or missing sheet of plywood can hold up the entire build. This can cost thousands of dollars per hour in lost productivity. Home Depot's unmatched store concentration – with 90% of the U.S. population within 10 miles of one of its stores – made it strategically positioned to provide the convenience and cost savings of quick store trips.

Best of all, this market was wide open for a national chain to exploit. At the time, professionals made up only about 10% of Home Depot's business, and an even smaller amount for Lowe's. Both companies de-emphasized this market segment because, unlike the DIY segment that paid premium prices, selling to professionals at wholesale meant lower profit margins.

But the upside came from the sheer size of the opportunity. In 2007, Home Depot's management team estimated the market for serving professional builders and contractors at $410 billion – twice the size of the $200 billion DIY market.

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From a financial perspective, Home Depot executives saw the opportunity to offer many of the same products it already sold to DIY consumers, but in much larger quantities. And by adding this new customer line, the company would not have to incur substantially more overhead for serving pro customers. Instead, it would invest in a new logistics infrastructure to push more sales through their existing store base. So even though bulk sales to contractors would come with lower margins on a per-unit basis, management expected a major uplift in overall profitability at the store level.

The Amazon of Professional Construction

Wall Street analysts were initially skeptical about the viability of going after the pro market. Despite this skepticism, in 2007 Blake launched a multibillion-dollar investment program to build new distribution warehouses, product-fulfillment centers, and delivery infrastructure to meet the volume demands of professional builders and contractors.

The company also invested heavily into improving the customer experience for these professional customers. Busy contractors making multiple store trips per day couldn't afford to wait in long checkout lines behind the DIY weekend warriors. So the company created Home Depot Pro accounts – offering members dedicated checkout lines and reserved parking. The company also built designated loading docks for pro customers, enabling seamless transport of bulk orders directly into their vehicles.

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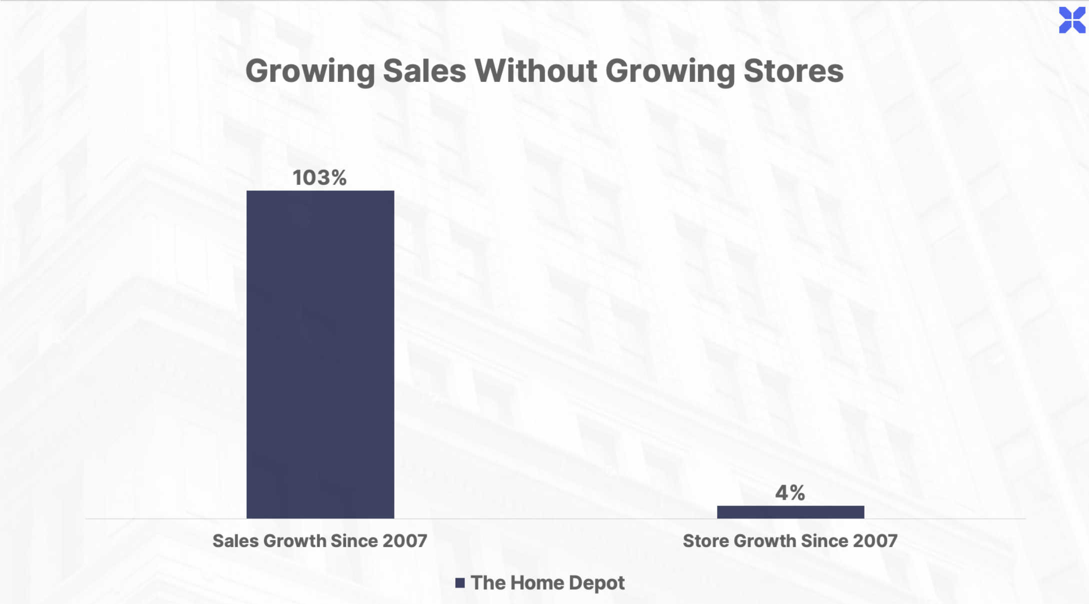
The company also built out a massive delivery system to ship items directly to the jobsite. This includes over 2,000 delivery vans and trucks and a series of flatbed distribution centers – allowing Home Depot to process massive orders of materials and equipment onto flatbed semi-trucks for bulk deliveries. Each of these delivery options can get orders to the job site on the same or next day.

It took several years for these investments to pay off. Progress stalled when the economy and thus the housing market entered a tailspin from 2007 to 2009. But starting in 2010, Home Depot's pro business began to boom. The fast-growing segment helped Home Depot reclaim its prior trend of outperforming its top competitor, Lowe's. Since 2010, Home Depot has generated higher same-store sales than Lowe's every year but one.

Since Home Depot began investing in its pro segment 15 years ago, sales in this segment have grown from $12 billion in 2007 to $80 billion today. This massive increase has made Home Depot the largest wholesale distributor of building supplies and equipment for the U.S. professional builders and contractors.

Today, Home Depot is no longer just a consumer home-improvement retailer. About 50% of its sales now come from distributing wholesale supplies to professional builders and contractors – up from just 10% in 2007. This isn't immediately clear to consumers who visit a Home Depot location. The pro customer driving half of its business only makes up 5% of its customer base.

Therein lies the magic of the pro-business segment. Before 2007, Home Depot relied on new store openings to drive sales growth. But after tapping into this tiny minority to drive outsized growth, Home Depot hasn't had to meaningfully expand its store count to grow its volumes. Since 2007, the company has doubled its sales despite only increasing its store count by 4%.



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Instead, through its world-class logistics network, the company found ways to sell more from its existing store base. Over the last 15 years, Home Depot has become the Amazon of professional building suppliers. Through more than 400 distribution and warehouse facilities, the company processes 15,000 tractor-trailer loads of goods each week. Home Depot also makes 60 million parcel deliveries each year, and is the third-largest shipping-container importer in the U.S.

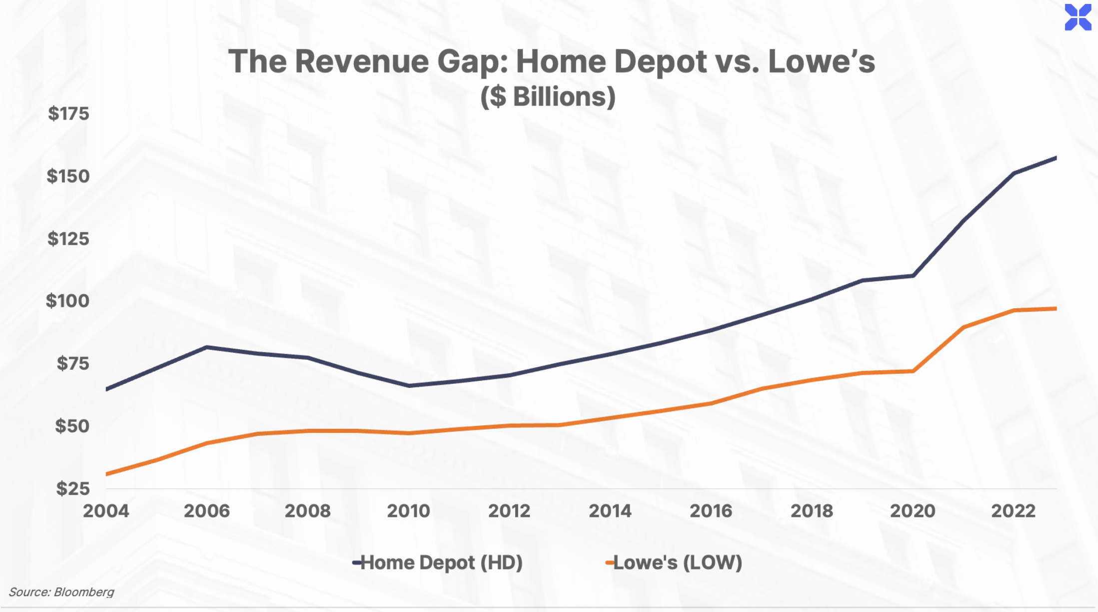
No other home-improvement company has come close to replicating Home Depot's dominant logistics infrastructure. And it has paid off handsomely, as reflected in Home Depot's sales volumes compared to Lowe's. Both companies sell a similar array of products to both DIY and pro consumers (although Lowe's pro business only makes up about 25% of sales versus Home Depot's 50%). But Home Depot does $60 billion more in total sales each year than Lowe's.

What's more, this dominant size gives Home Depot the greatest bargaining power in the industry for obtaining the best prices from suppliers. It can then pass these low costs on to its customers.

A Self-Reinforcing Competitive Advantage

Home Depot's unmatched scale has become a self-reinforcing structural advantage, whereby better pricing power leads to more business, and more business leads to better pricing power. This is a powerful and growing competitive moat found in other world-class retail giants, like Walmart, Costco, and Amazon.

Home Depot's successful expansion into the pro market has allowed the company to extend its advantage over the competition. Since 2010, Home Depot's revenue lead – how much more it sell compared to a competitor – versus Lowe's has grown from $19 to $60 billion today:



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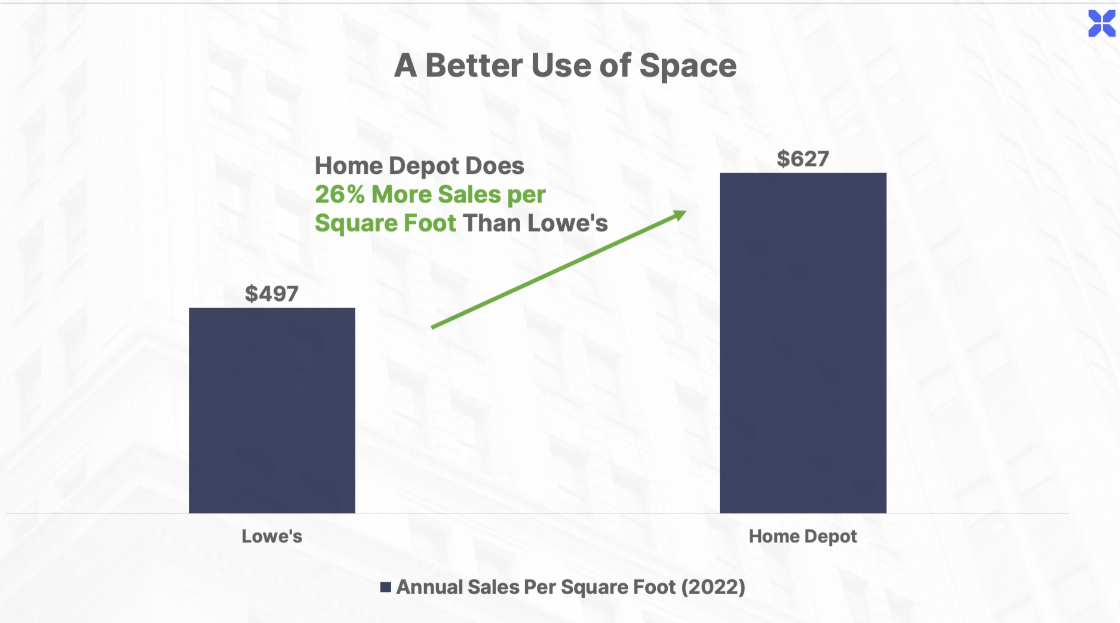
The other benefit of building the world's largest home-improvement logistics network has shown up in Home Depot's burgeoning e-commerce business as well.

Home Depot launched its e-commerce options for both DIY and pro consumers in 2010. The company's massive logistics network makes it possible for online consumers to tap into an even wider inventory selection beyond what's stocked in stores – and the company can ship directly from distribution centers to customer homes or work sites. This has further extended Home Depot's long-running advantage of offering the biggest product selection in the industry, for both professionals and DIY consumers.

Home Depot is the fifth-largest e-commerce retailer in the U.S. – behind category leaders Amazon and Walmart – but number one in the home-improvement category (Lowe's has yet to crack the top 10). We expect this lead to expand, as Home Depot is the only home-improvement business that can offer guaranteed two-day delivery options for 80% of the U.S. population – with a goal of reaching 90% in the coming years. The company also offers same-day delivery for customers who pick up online purchases at their nearest store.

By leveraging its best-in-class logistics network, Home Depot leads the industry in making the most efficient use of its store space. Last year, Home Depot generated $627 in sales per square foot of retail space – or 26% more than Lowe's $497 in sales per square foot:



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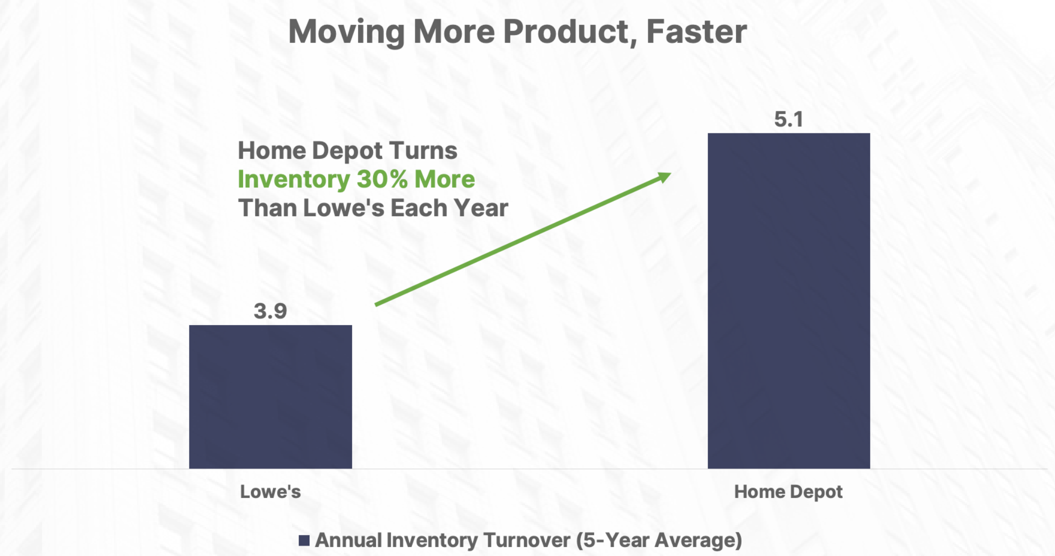
Another key metric for the efficiency of a retail business is inventory turnover. This refers to how fast a company can sell its products over a given year. The faster a company can sell inventory, the less it ties up its precious capital. Over the last five years, Home Depot has turned over its inventory 5.1 times per year, or 30% more than Lowe's:



Logistics Investments Boost Home Depot's Capital Efficiency

By leaning on its investments into its logistics network to drive more sales from its existing store base, Home Depot has enjoyed tremendous operating leverage over the last 15 years. As a result, the business has grown sales without incurring a similar increase in overhead like rent, utilities, and labor.

Since 2007, Home Depot's revenues have doubled while its employee count has grown by only 42%. Because of this, the company has boosted its profit margins from 7% to 11% since 2007 – making it nearly twice as profitable as Lowe's, which generates 6% margins.

Best of all, the money Home Depot invests into its logistics network goes much farther than similar investments into new store openings. Today, Home Depot only spends 2% of sales on capital expenditures, down from over 4% in 2007 – freeing up $6 billion a year to be used elsewhere. This has unlocked a substantial increase in its capital efficiency.

Since 2007, Home Depot's return on invested capital has grown from 21% to 37%. This high capital efficiency allows the business to return large amounts of cash to shareholders, through dividends and buybacks.

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Since 2007, consistent buybacks have slashed Home Depot's share count by 50%. Over the same period, the company has grown its annual dividend payout nearly 10-fold, from $0.90 to $8.36 per share.

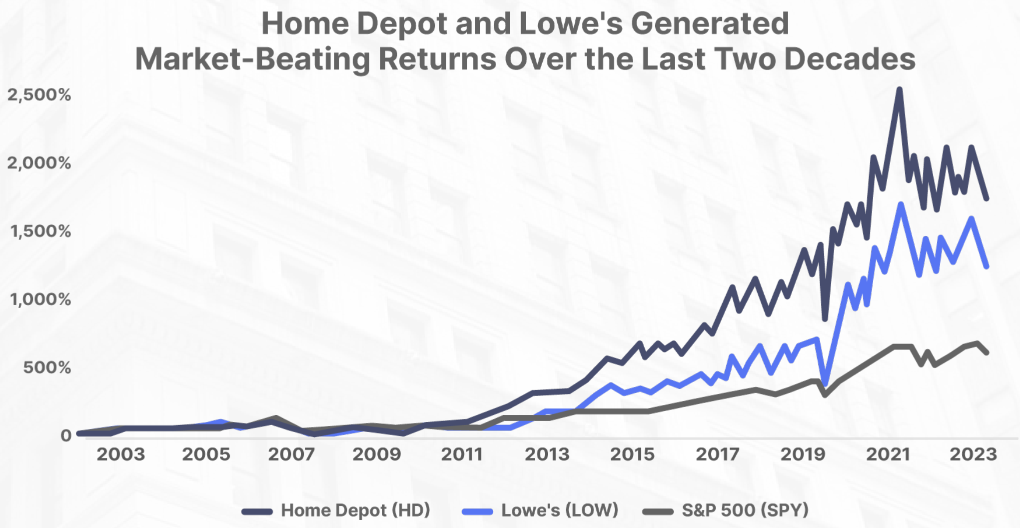
This performance enables Home Depot to deliver world-class returns to shareholders. Even investors who bought shares in January 2007, on the cusp of the worst housing downturn since the Great Depression, have earned a 15.4% compounded return since then. Those who invested in 2010, when the economy and housing market bottomed out, have secured an incredible 21% compounded annual return.

Despite Home Depot's massive success to date, it's still in the early innings of a long growth trajectory. The company estimates the total size of its addressable market among the DIY and professional market is $950 billion, split roughly equally between the two segments. Holding less than 20% of the total market share today, Home Depot still has decades of runway for highly profitable growth.

A Dominant Duopoly, Led by Home Depot

So far, we've focused on comparing Home Depot against Lowe's, its top national chain competitor. But the real fight is not between these two industry giants. Instead, they're both taking share from a highly fragmented market, in which the majority of products are still sold through local mom-and-pop stores and regional chains.

Both Lowe's and Home Depot enjoy a significant scale advantage over these much smaller rivals. That's how the two companies have peacefully coexisted and prospered in a duopolistic market structure, both generating market-beating returns for decades:



Source: Bloomberg

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Given that Home Depot and Lowe's together control roughly one-third of the $950 billion (and growing) home-improvement market, we see a vast opportunity ahead for both companies to continue taking share from their smaller rivals. And Home Depot is better positioned to lead in those market share gains.

Home Depot's unmatched scale is an enduring, self-reinforcing competitive advantage that grows stronger over time. Its dominant logistics network means the business can offer the greatest selection of inventory with world-class convenience, to both DIY and pro consumers. Its scale gives it the industry's best bargaining power to obtain the lowest prices from suppliers. As mentioned earlier, this allows Home Depot to pass on the cost savings to consumers, driving more market-share gains over time. Home Depot's growing profit stream can then be reinvested into building an even more dominant logistics and scale advantage in a virtuous cycle.

Given Home Depot's entrenched and growing competitive advantages, it's what we call a "forever stock" – an investment to buy and hold forever. As its advantages compound over time, we have a high degree of confidence that both DIY and professional consumers will continue choosing Home Depot over the competition for decades to come. And as Home Depot benefits from continued economies of scale, its business will continue becoming more profitable. Along the way, we expect the company will return a substantial portion of those profits to shareholders, through dividends and buybacks.

That means shareholders can expect to continue benefiting from a growing earnings stream, spread over a shrinking share count.

Looking at the Stock's Value

The only question is, what's the right price to own shares of Home Depot?

Since 2010, Home Depot shares have traded in a range between roughly 16x to 30x earnings. The stock currently trades near the low end of its historic valuation – at just over 17x earnings.

From 2010 to 2022, the shares climbed from $28 per share to $325. These share price gains, plus the dividends paid along the way, generated a compounded annual return of 21%, compared with a 13% annual return in the S&P 500.

The company's share price has fallen in recent months, as the company's earnings per share have contracted modestly from a record high of $16.69 in its fiscal year 2023 (which ended in January 2023) to $16.01 over the last four quarters.

The company has faced two recent external obstacles: 8% mortgage rates that have slowed home demand and construction, plus a mean reversion in the pandemic-driven boom in home remodeling. Next up, we expect a broader economic slowdown and a contraction in consumer spending to deliver a third blow to Home Depot's short-term profitability.

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After a temporary decline from the upcoming recession, we're confident demand for Home Depot's products will recover in the coming years.

America's Decade-Long Housing Shortage and an Aging Housing Stock

As we detailed in our **April 2023 recommendation** of asset-light homebuilder Dream Finders Homes (DFH), America faces the prospect of a decade-long housing shortage. Following the housing bust following the 2008 Great Financial Crisis, home builders pulled back on construction.

In decades past, the rate of new home construction has kept pace with household formation (defined as a group of people occupying a private home, regardless of their relationship status). But from 2012 to 2022, U.S. builders completed 11.9 million new homes, compared with 15.6 million household formations. As a result, a record 6.5 million gap emerged between household formation and single family homes as of year-end 2022. The demand for new homes to fill this gap will translate into long-term demand for Home Depot's products – thus growing sales in the coming years.

Not only will the housing shortage lead to more new home construction, but it will also create huge new demand for repairs and renovation. Because of the lack of new housing supply, America's housing stock is aging. Today, 50% of U.S. homes are more than 40 years old. That means a growing need for home-improvement supplies to fix a dripping faucet, worn-out roofs, and flickering lighting fixtures.

As a result, we're adding Home Depot to the watchlist today, to buy below $240 per share. This price is 20% below Home Depot's current share price of $288, and reflects a 15x multiple relative to the last 12 months of earnings.

Action to Take: Add The Home Depot (NYSE: HD) to the watchlist and buy shares below $240 per share.

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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 on Wall Street*, we highlight three current portfolio picks that are at an attractive buy point.

1. **PayPal (Nasdaq: PYPL)** is one of the world's largest digital payment networks, originally founded as X.com by Elon Musk in 1998. PayPal became the largest and most trusted digital-payment option on auction site eBay and other online merchants in the late 1990s and early 2000s. PayPal was later spun out into a standalone company, and today is the most widely adopted payment option among the world's largest online merchants, with over 430 million users. The business is highly capital efficient, with 20% free cash flow margins. Misplaced fears of rising competition have caused shares to trade at their lowest valuation on record, at just 10x earnings. PayPal's unmatched payments ecosystem has created an enduring competitive advantage, allowing the company to maintain a double-digit growth rate in payment volumes and earnings per share. PayPal's high capital efficiency allows the company to return a lot of cash to shareholders, including a $5 billion buyback in 2023 – or nearly 9% of its current market capitalization.

2. **Credit Acceptance Corp (Nasdaq: 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. Over the last 10 years, CACC has generated an average of 38% profit margins and 33% returns on invested capital. (It's at a buy point of $410 per share, or less than 18x earnings.) Shares have sold off on fears of a subprime auto-lending meltdown, but as we'll explain in today's portfolio update, CACC is well-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. As the subprime auto bubble has turned to a bust, and many of its competitors in retreat, CACC has grown its loan volumes at double digit rates for the last five quarters in a row.

3. **Viper Energy Partners (Nasdaq: 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 invests any capital 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 13% free cash flow yield – the best valuation since the depths of the COVID-19 pandemic. The company is returning capital to shareholders through a 5% dividend yield and a repurchase program that has reduced outstanding units by roughly 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	06-02-2022	$48.87	$39.41	1.23%	$0.75	-17.82%	Buy Under $50	4
TELLURIAN INC.	TELL	U.S. LNG Exporter	06-16-2022	$3.82	$0.55	0.00%	$0.00	-85.60%	Buy Under $5	5
VIPER ENERGY	VNOM	Oil and Gas Royalty	09-01-2022	$29.68	$29.20	4.93%	$1.67	4.01%	Buy Under $34	3
BWX TECHNOLOGIES, INC.	BWXT	Nuclear Power Equipment	12-22-2022	$58.05	$75.27	1.22%	$0.69	30.85%	Buy Under $80	3
BLACK STONE MINERALS	BSM	Oil and Gas Royalty	02-16-2023	$15.90	$17.03	11.27%	$0.48	10.09%	Buy Under $18	2
BITCOIN	BTCUSD	Cryptocurrency	05-11-2023	$27,011.85	$36,541.55	0.00%	$0.00	35.28%	Buy Under $35,000	4
PEABODY ENERGY	BTU	Coal Mining	06-22-2023	$21.29	$22.61	1.33%	$0.00	6.20%	Buy Under $25	4
CNX RESOURCES	CNX	U.S. Gas-Focused E&P	09-28-2023	$22.82	$20.89	0.00%	$0.00	-8.46%	Buy Under $30	3
BATTLESHIP STOCKS										
CREDIT ACCEPTANCE CORP	CACC	Consumer Finance	07-28-2022	$560.28	$410.32	0.00%	$0.00	-26.77%	Buy Under $600	3
NOVO NORDISK	NVO	Pharmaceuticals	10-27-2022	$53.30	$100.03	3.53%	$2.07	91.56%	Hold	2
WINMARK CORPORATION	WINA	Specialty Apparel Stores	09-15-2022	$217.60	$431.75	0.74%	$6.00	101.17%	Hold	1
FRANCO-NEVADA CORP	FNV	Precious Metals Streamer	05-11-2023	$154.77	$120.07	1.13%	$0.68	-21.98%	Buy Under $170	2
PAYPAL	PYPL	Payment Processor	07-20-2023	$73.02	$54.28	0.00%	$0.00	-25.66%	Buy Under $90	3
FOREVER STOCKS										
ALTRIA	MO	Tobacco Maker	07-14-2022	$41.63	$40.10	9.78%	$4.74	7.71%	Buy Under $50	1
PHILIP MORRIS	PM	Tobacco Maker	07-14-2022	$89.62	$89.80	5.79%	$6.38	7.32%	Buy Under $100	1
DOMINO'S PIZZAS INC	DPZ	Restaurants	02-27-2023	$300.00	$369.69	1.19%	$2.42	24.04%	Hold	3
DEERE & COMPANY	DE	Agricultural Machinery	08-31-2023	$410.94	$369.62	1.46%	$1.35	-9.73%	Buy Under $450	3
INCOME & DISTRESSED DEBT										
MICROSTRATEGY INC	CUSIP: 594972AC5	2025 Convertible Bond	10-13-2022	$758.00	$1,371.14	0.55%	$7.50	81.88%	Sell to Close Nov. 9, 2023	4
SABA CAPITAL INCOME & OPPORTUNITIES FUND	BRW	High Yield Bond Fund	03-16-2023	$7.70	$7.49	13.62%	$0.60	5.08%	Buy Under $9	3
OAKTREE SPECIALTY LENDING CORP	OCSL	Specialty Investments	03-30-2023	$18.57	$19.59	11.23%	$1.10	11.42%	Buy Under $22	2
PROPERTY & CASUALTY INSURANCE										
W.R. BERKLEY	WRB	P&C Insurance	05-25-2023	$56.10	$67.41	0.59%	$0.61	21.25%	Buy Under $62	2
PROGRESSIVE CORPORATION	PGR	P&C Insurance	06-08-2023	$131.08	$160.34	0.25%	$0.20	22.47%	Buy Under $160	2
CHUBB LIMITED	CB	P&C Insurance	06-08-2023	$191.60	$218.77	0.18%	$1.72	15.08%	Buy Under $220	2
SKYWARD SPECIALTY	SKWD	P&C Insurance	06-16-2023	$24.66	$30.35	0.00%	$0.00	23.07%	Buy Under $35	2
BETTER THAN THE MARKET										
CAMBRIA SHAREHOLDER YIELD	SYLD	Yield Focused ETF	01-05-2023	$59.67	$59.25	2.62%	$1.17	1.25%	Buy Under $65	2
WATCHLIST										
NVR, INC.	NVR	Homebuilder	NA	-	$5,832.01	0.00%	-		Buy Under $3,500	
FREEPORT-MCMORAN	FCX	Base Metals	NA	-	$33.24	1.81%	-		Waiting For Recession	
SOUTHERN COPPER CORP	SCCO	Base Metals	NA	-	$69.89	4.29%	-		Waiting For Recession	
SHERWIN-WILLIAMS	SHW	Specialty Chemicals	NA	-	$252.35	3.84%	-		Buy Under $150	
ULTA BEAUTY	ULTA	Specialty Retail	NA	-	$388.85	0.00%	-		Buy Under $350	
NIKE	NKE	Athletic Footwear & Apparel	NA	-	$107.01	0.00%	-		Buy Under $75	
HOME DEPOT	HD	Home Products Stores	NA	-	$287.87	2.90%	-		Buy Under $240	

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. Cost basis refers to the closing price the day before a security is recommended.

An Attractive Fixed Income Alternative to Stocks

In our previous portfolio update, we made the case for a golden age of debt investing. We explained how today's higher-interest-rate environment now offers equity-like returns for various fixed-income investments, which can come with less risk than today's richly valued stock market.

One vehicle capitalizing on this opportunity is the **Saba Capital Income & Opportunities Fund (NYSE: BRW)**, managed by legendary investor Boaz Weinstein. BRW is a closed-end fund ("CEF"). Like open-end vehicles, including mutual funds and ETFs, CEFs are publicly traded funds that own a basket of other publicly traded securities. The net asset value (NAV) reflects the total value of securities and cash held by the fund, which gets reported on a daily basis.

The key difference between these two structures is that CEFs have a fixed share count, whereas open-ended funds create and extinguish shares as investors buy and sell the fund. When investors purchase shares in an ETF, for example, the ETF manager creates new shares and buys new assets in proportion to the amount of incoming funds (and vice versa when investors sell). CEFs, on the other hand, do not issue or redeem new shares when investors buy and sell the fund. This means that any imbalance between buyers and sellers for CEF shares causes the price to trade at a discount or premium to NAV.

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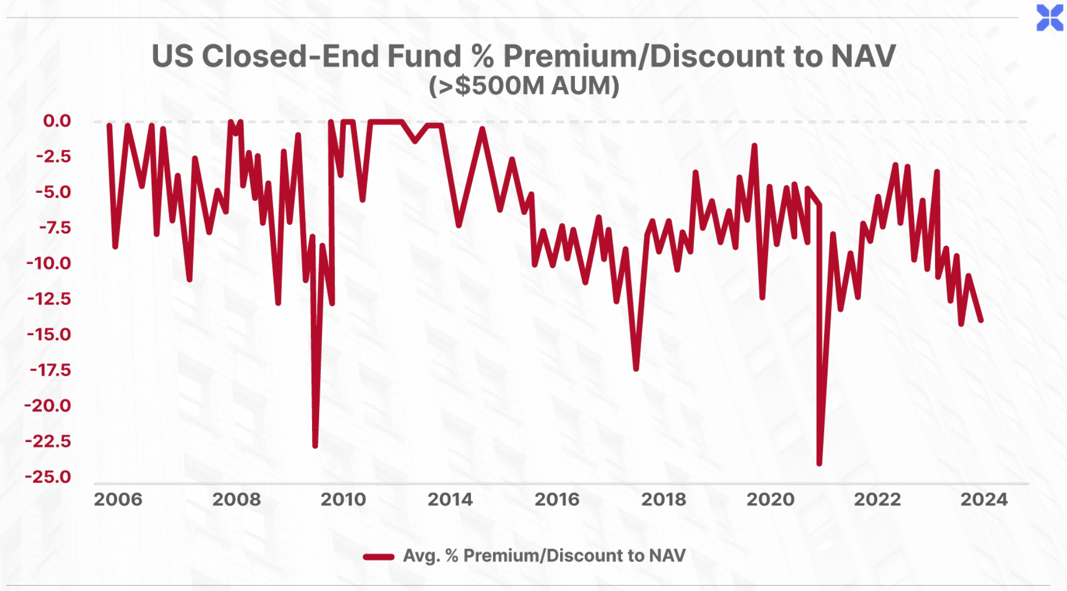
BRW specializes in identifying and buying CEFs trading at large discounts to NAV. BRW then attempts to unlock value through a variety of mechanisms, including activist shareholder campaigns that can force a liquidation of assets or a conversion of a CEF to an open-end fund. By converting CEFs to an open-end fund, or liquidating the assets and returning proceeds to investors, the share price will converge with the NAV. So when closed-end funds are trading at a significant discount to NAV, this creates a target-rich environment for BRW to find these diamonds in the rough and unlock gains for BRW's investors.

Today, closed-end funds are trading at large discounts across the board.



BRW monitors 750 closed-end funds daily looking for the widest discounts to NAV. CEFs currently make up about one-third of BRW's portfolio. BRW yields 14% today, and offers upside from the distress we see hitting the U.S. debt market in the months ahead with 58% of its portfolio short as of the end of Q3.

Another legendary investor that's capitalized on the opportunities in CEFs is Warren Buffett. In a 2018 correspondence with Weinstein, Buffett shared the portfolio holdings of his hedge fund, Buffett Partnership, from 1950. In 1950, two-thirds of Buffett's portfolio consisted of discounted CEFs, a strategy he used to outperform the market, while also taking less risk throughout that decade.

BRW, the hedge fund-style investment vehicle, takes a page out of Buffett's 1950s playbook.

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Just like Buffett in the 1950s, BRW is positioned to deliver market-beating returns – especially if financial markets come under pressure, as we expect in the coming months. Financial distress typically causes CEF discounts to widen. Given Weinstein's specialty in navigating the booms and busts in financial markets, BRW provides a great vehicle for investors to profit from the distressed-debt environment we see coming, as well as an attractive yield today.

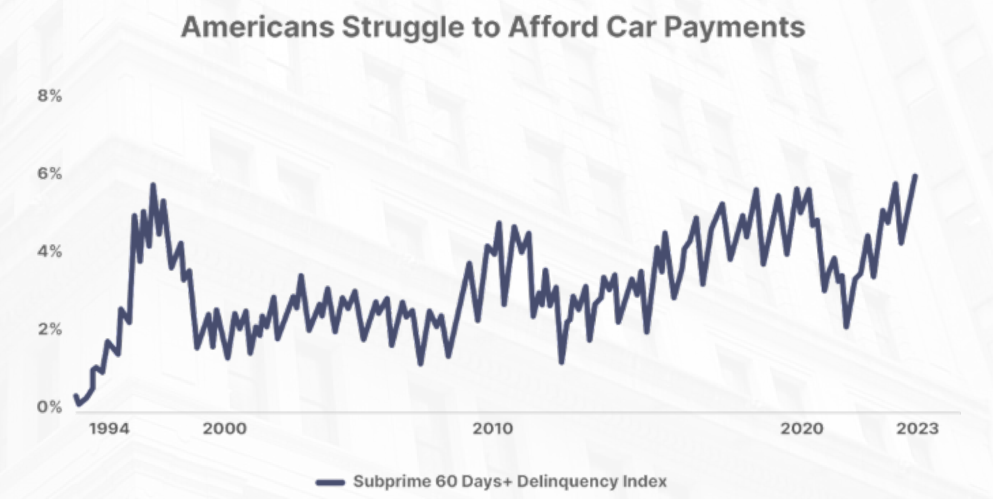
BRW is currently trading at $7.49 per unit, or an 11% discount to its NAV of $8.38 per unit. Since January 2019, when Weinstein first acquired a stake in the Voya Prime Trust – the CEF that was eventually converted into BRW – the fund has traded at an average discount of 9% to NAV. With a 14% yield and an 11% discount to NAV, plus upside from further distress in financial markets, we continue to recommend investors buy units of the Saba Capital Income & Opportunities Fund (NYSE: BRW) up to $9 per unit.

CACC Takes Market Share as Subprime Bust Accelerates

Subprime auto lender **Credit Acceptance (Nasdaq: CACC)** reported Q3 earnings on October 30. The company is currently facing the crosscurrents of rising loan delinquencies, offset by higher volume growth as it takes market share from its weaker competitors.

As **we highlighted** in our previous issue, consumers have come under pressure from higher borrowing costs and the exhaustion of the COVID-era stimulus savings. According to *Bloomberg Intelligence*, excess savings for U.S. consumers have fallen to just $148 billion, down from a peak of $2.1 trillion in August 2021.

As a senior director from ratings agency Fitch recently noted, "the subprime borrower is getting squeezed." Web searches for "give car back" have reached an all-time high, and subprime auto loan delinquencies have reached the highest level since 1994. The chart below shows the percentage of existing auto loans that are at least 60 days past due – from 1994 until today.



Source: Fitch Ratings

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In the near-term, consumer distress is a negative for CACC's financial performance, causing losses among its existing loan portfolio. In Q3, CACC's provision for credit losses – the money set aside to cover expected future loan losses – increased to $573 million for the nine months ending on September 30, compared to $351 million the prior year.

Despite rising loan losses, CACC's business model has remained more resilient than many of its peers. CACC differs from traditional auto lenders because it structures its loans with a high margin of safety. Before originating each loan, CACC collects an upfront fee to protect the downside. The upfront payment CACC receives from its dealership partners means the dealership takes on losses before CACC takes a hit. And because CACC retains the lien on each vehicle, CACC gets paid back first when vehicles get repossessed and sold to recover the loan value.

Despite rising loan losses over the last 12 months, CACC still managed to generate $412 million in net income – or $24.09 per share. Meanwhile, many of CACC's competitors are going bust, allowing the company to aggressively increase market share.

In Q3, despite the overall industry pulling back on loan origination, CACC grew loan volume by 13%. This reflects CACC's fifth consecutive quarter of 10% or greater loan-volume growth. CACC's management noted continued robust loan growth in October, as they described on their Q3 earnings call:

> *"I think we think the competitive environment is relatively favorable today. We grew the loan portfolio, we grew originations in Q3 or rates that we're happy with.* ***Volume through the first 28 days of October is up materially.*** *So, I think the competitive environment is favorable. The October volume would indicate that it's been even more favorable recently."*

Despite the near-term hit to earnings from rising loan losses, CACC is setting the stage for robust future growth. While most of its competitors are retrenching, CACC is consistently growing loan volumes by double-digit rates.

CACC is well-positioned with its high margin of safety to continue to generate earnings and capture greater market share, just as it did during the previous subprime lending bust from 2007 to 2009. Just as it did back then, we expect CACC will rebound from today's credit bust stronger than ever, with a long runway of growth and profitability ahead.

We continue to recommend investors buy shares of Credit Acceptance (CACC) below $600 per share.

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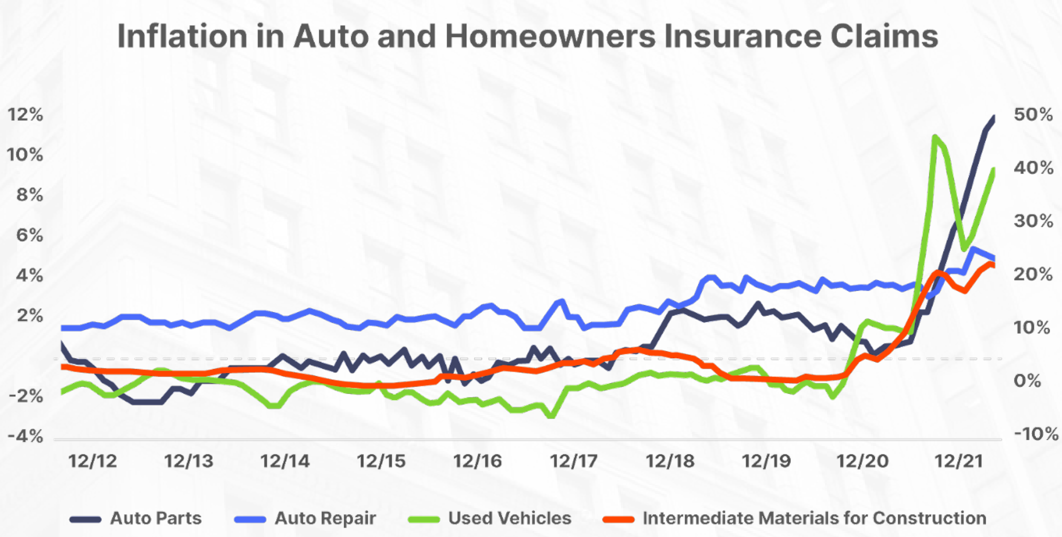
An Update on Our Property & Casualty Insurance Plays

Earlier this year, we added three Property & Casualty (P&C) insurance companies to our portfolio: **Chubb Ltd. (NYSE:CB)**, **Progressive Corp (NYSE:PGR)**, and **Skyward Specialty Insurance Group Inc (Nasdaq:SKWD)**. We like the capital efficient P&C sector for many reasons – notably, its negative cost of capital (otherwise known as free money).

Good insurance companies are good underwriters, which means they focus on finding customers who are statistically less likely to file a claim. Over the years, these responsible customers pay premiums every month. And all those premiums build up to create an enormous buffer of "free" money called *float*, which the insurance company can then reinvest into other businesses. (Warren Buffett has built an empire by doing this very thing.)

Over the past three years, however, even excellent P&C insurance companies have been struggling. While smart underwriters still pay out a smaller number of claims on average, the amount of money they shell out for those claims (known as *loss costs*) has been steadily rising.

Inflation is the culprit. Auto parts, for instance, cost much more in a high-inflation environment (the price of auto parts rose 22.8% from June 2021 to June 2022). Building supplies have similarly risen sharply. And even workers' compensation – and litigation fees – have also moved up in price. As a snapshot, in 2021 alone, the insurance business logged an extra $30 billion in loss costs, with inflation a major factor.



Source: Bloomberg

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However, after a year of interest rate hikes by the Federal Reserve, inflation in the U.S. has now cooled from 9.1% to 3.7% – still higher than the benchmark 2%, but moving in the right direction. This means that loss costs in the P&C business should also start to decline in 2024 and 2025 – and smart underwriters will be able to add much more money to their float.

In addition, each of the three insurance companies in our own portfolio has recently seen positive developments…

Chubb Corp Bucks the Trend

Over the past three quarters of 2023, Chubb's earnings have increased each quarter from 5% to 15% to 58% in Q3 2023. Moreover, Chubb's loss costs are trending lower while it steadily brings in more money from premiums.

In its homeowner's business, for example,

CB achieved 15% price increases in premiums while its loss cost trend was 10.5%. Pricing for commercial P&C was up 13.9% while trending loss costs in North America were 6.7%, same as last quarter. That means we see loss costs on commercial lines stabilizing while prices increase steadily.

Growth Opportunities Abound for Skyward Specialty Insurance

A large amount of Skyward Specialty's year-to-date outperformance has occurred since early September 2023. This is an indication that the market is just beginning to recognize the significant growth potential of SKWD in the Excess & Surplus (E&S) business… which insures unusual risks, like skydiving or medical accidents. (E&S insurance costs more than mainstream insurance, largely because it's backed by a smaller, less bureaucratic regulatory body.)

E&S also insures an increasing number of properties in disaster-prone areas (think hurricanes or wildfires) that "standard" insurance carriers won't touch. As we wrote in our initial report, if you live in certain areas of Florida or California, you may *have* to take out higher-priced home insurance from an E&S company, because standard insurance companies like Farmer's and AAA have fled the state altogether.

Skyward is still relatively small, so it could evolve into a "growth stock" story as premium rates rise dramatically while its core E&S market expands.

Progressive Corp Responds Positively to New Market Dynamics

In the third quarter of 2023, Progressive's combined ratio (the measure of underwriting profitability) returned to more normalized levels while the company maintained excellent premium growth. This means that earnings momentum is accelerating at a faster pace than revenue growth. Hence, margins are improving.

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Because PGR tends to be viewed as a growth stock, its valuation has always been somewhat hefty. However, with loss cost inflation expected to decline over the next couple of years and past rate hikes filtering through, the top-line growth and near-term earnings momentum more than justify the current price-to-earnings (P/E) multiple of roughly 19× 2024 earnings expectations.

Taking Profits on the Bitcoin Bond

The recent rally in Bitcoin has propelled the price of the Microstrategy 2025 **convertible bond** (the Bitcoin Bond) to nearly $1,400 versus our $758 entry price. In our original recommendation, we explained how this convertible bond offered a better risk/reward proposition for getting exposure to Bitcoin prices compared with owning Bitcoin outright.

Now that the price of the bond has increased by over 80% since our original recommendation, this risk/reward proposition has shifted. The Microstrategy convertible bond now presents more downside risk than simply owning Bitcoin itself. As a result, we are exiting this position, and recommend investors reinvest a portion of their proceeds into Bitcoin.

For the purposes of our model portfolio, we'll record Thursday's closing price of $1,370 as our official selling point. Including the $7.50 in interest payments, we're booking a total return of 82% on this position.

We will keep an eye on this bond to potentially recommend it once again if the price reaches an attractive level.

Action to Take: Sell the Microstrategy ¾ convertible bond maturing 12/15/2025.

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Mailbag

In *The Big Secret on Wall Street* 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** to have your questions answered. We'd love to hear from you!

Today's letter comes from B.P. who writes:

> *"Porter, I have my major retirement funds in tax-free municipal bonds on a five-year ladder system. As the financial picture develops, would this strategy hold or could there be a better use of these funds?*
>
> *I have gold and cash, but I'm concerned about the best use of the majority of my funds in municipal bonds.*
>
> *I appreciate your suggestions above all other reports I receive. Happy and comfortable to be an initial subscriber."*
>
> **Porter's comment: Thank you for the question and for being an early subscriber.**
>
> **While I can't give you individual advice about your personal financial situation, I can comment generally about the strategy of holding government bonds as a source of income.**
>
> **Given the current risks in the financial markets, short-duration bonds yielding over 5% with zero risk is the ultimate no brainer. But I urge caution in owning any government bonds with durations greater than one to three months. The problem is, when the financial storm I expect unfolds in the coming months, the authorities will likely respond with another record bout of fiscal and monetary expansion.**
>
> **In this scenario, inflation will likely exceed the rates of return currently offered on government bonds. This means anyone holding bonds will likely suffer a real loss on their investment. Unfortunately, this is by design – the only politically viable escape from our current fiscal situation is to inflate away the government's obligations.**
>
> **That's why my suggestion for anyone hoping to outpace inflation is to put yourself in a position to buy equity stakes in the world's most-dominant, capital efficient businesses during the upcoming crisis. That means not tying up capital in long-duration, fixed-income investments. Instead, I suggest owning shorter-term bonds – and other stores of value like gold and Bitcoin that can be easily liquidated. When the time comes, investors want the ability to replace government bonds and other safe assets with shares of world-class, capital efficient businesses.**

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These businesses have the means to raise prices and grow their earnings power without spending a lot of money investing in capital equipment. In this way, shareholders will benefit from a growing stream of earnings and shareholder returns when inflation inevitably returns.

Consider a tangible example. Let's rewind the clock 10 years, and imagine having made a $10,000 investment in a business like Home Depot, versus a 10-year Treasury bond or gold.

Back then, shares of Home Depot traded for $78 and the stock paid out $240 in annual dividends. At the same time, 10-year U.S. Treasury bonds paid $280 in annual income. Meanwhile, gold traded for $1,200 per ounce.

Fast forward to today, and the Treasury bond is still paying out the same $280 in annual income. When it matures, holders will get paid back the $10,000 in principle. Gold hasn't paid anything along the way, but the original $10,000 investment has appreciated to around $16,700.

In the case of Home Depot, the income generated on the original investment has soared from $240 to $930 in annual dividends. Importantly, this assumes no dividend reinvestment. If you reinvested dividends along the way, you now own 22.6% more shares than you did 10 years ago, without paying a dime of extra capital to own those shares. In this case, the original investment now pays out $1,140 in annual dividends – or four times more than the Treasury bond.

Finally, Home Depot's share price has also increased from $78 to $288. So not only is Home Depot generating four times the income as the Treasury bond, but the principal investment has appreciated from $10,000 to by $26,700.

Looking ahead, I suspect that 10 years from now, Home Depot will likely be generating substantially higher dividend returns versus any comparable U.S. government bond purchased today. And I also suspect the capital appreciation in Home Depot will handily outpace gold on a total return basis.

Buying world-dominating businesses that can consistently grow earnings and reduce their share counts, and thus pay an ever-higher dividend over time, is the ultimate way to outpace inflation and grow wealth in real terms. The only trick is to buy at the right price. That's why my number-one suggestion is to be in a position to buy these businesses when the time comes that they trade at attractive prices.

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> **Keep capital liquid, including fixed-income investments. This might mean giving up a little bit of extra income in the near term. But it will provide the flexibility to buy world-class businesses at attractive prices when the time comes. Over any reasonably long-time horizon, there's simply no better way to preserve and grow wealth. And I believe the time is coming when the market will temporarily offer shares in these kinds of businesses at fire-sale prices.**

Porter Stansbury

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Stevenson, MD

P.S. If you'd like to learn more about the Porter & Co. team you can get acquainted with us **here**. You can reach me (Porter) personally via:

@porterstansb

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