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THE BIG SECRET ON WALL STREET

AMERICAN VICE #3

THE BIG TOBACCO

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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The Big Tobacco

Lucky Lopez buys repo'd cars.

He's a 20-year veteran of the auto industry. As a car dealer and auction buyer, Lopez sits on the frontline of the auto financing market. He's even got a YouTube Channel that's popular with dealers.

According to Lucky, prices are collapsing, and inventory is piling up, fast.

He believes the sudden turn in the market is going to hit subprime buyers and lenders hard. Lucky says, "*in 2008 we had a housing bubble, and now we have an auto bubble*."

In recent years, bank lending standards for car loans "went out the window." Lopez reports banks routinely offered auto debt with a "loan-to-value" ratio of 140%. This means banks would write a loan for 40% more than the value of the underlying vehicle.

Of course, this is bad business in any market. But in today's car market, these loans are set for a spectacular collapse.

Here's the story...

COVID-19 disrupted supply chains across the board. Including those for carmakers. Meanwhile, the stimulus bonanza gave incomes a jolt, allowing consumers to bid up a limited supply of vehicles.

That's how the average new car price spiked to a record $47,077 by December of 2021. While used car prices jumped above $30,000 for the first time ever.

Recently, when those stimulus payments dried up, and real wages plunged, undeterred consumers binged on debt to finance ever-higher vehicle costs. Federal Reserve data shows the average consumer is taking out a record $40,300 in debt to finance new vehicle purchases, up 24% from 2019.

Car loans have become one of the largest and fastest growing segments of consumer credit in recent years. The volume of outstanding loans has doubled to over $1.6 trillion over the last decade. Today, autos make up the third largest

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source of consumer credit in America.

Lenders encouraged the boom by loosening up loan standards, including issuing loans to lower quality, subprime borrowers. They also kept monthly payments low by extending the duration of loans.

In the old days, the longest-term loan you could get for a vehicle was 48 months. After all, we're talking about a depreciating asset. But lenders found they could suck people into buying more car than they could really afford by offering a lower monthly payment through a longer-term loan.

It started with the introduction of 60-month car loans, which then grew to 72 months. Today, you can finance a car with an 84-month loan. That's seven years.

And many Americans are doing exactly that. Experian data shows that 32% of new car purchases in the first quarter of 2021 were financed with loans ranging between 73 – 84 months in duration. Another 39% of loans were issued with terms between 61 and 72 months.

While these longer durations can help keep the monthly payments low, consumers ultimately pay a high cost – paying nearly twice the value of the vehicle in financing costs in some cases, like the example shown below:

What One Loan Will End Up Costing

A 2018 Toyota Camry loan in Maryland, from CR's data analysis

Borrowed
$34,943
at 19% APR

Total Payment
$58,785
Over 6 years

Source: CR analysis of 857,904 loans obtained through the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

Meanwhile, a growing number of these loans were issued to subprime borrowers – those with poor credit histories. The percentage of subprime borrowers in the market has increased from roughly 10% of all auto loans in the 1990s to nearly *double* that number today.

How many of these subprime loans could go belly up?

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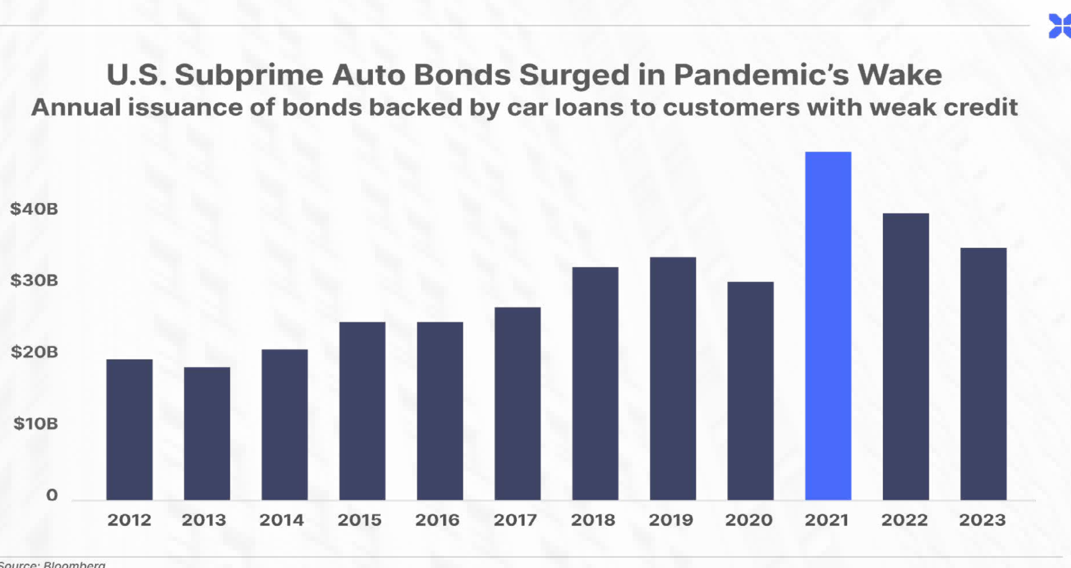
Back in 2017, the Attorney General of Massachusetts claimed that one of the leading subprime auto lenders – Santander – estimated that 42% of its loans to Massachusetts residents were expected to default. Of course, the problems have only ballooned since then...

In 2021, subprime auto issuance surged to $44 billion, or nearly 50% above the previous all time high:



Just like the real estate boom of the early 2000s, a big contributor to this subprime auto lending fiasco is the lack of income verification. Consumer Reports analyzed over 800,000 loans from 17 major auto lenders and found that 96% of borrowers did not have their income verified.

The Consumer Reports analysis also showed the bulk of borrowers taking on more debt to finance their car than they can afford. A commonly cited threshold for the maximum auto payment is no more than 10% of a consumer's monthly income should go towards an auto loan. But nearly 25% of the loans Consumer Reports analyzed blew past this threshold.

And perhaps the most eye-opening statistic of all – 46% of the loans in the Consumer Reports study were underwater on their loans. On average, consumers owed $3,700 more than the vehicle was worth.

All that debt is becoming hard to carry.

With inflation spiking to the highest levels in over 40 years in 2022 and continuing to run hot today,consumers are now getting squeezed by soaring costs for housing, gasoline, food, and other basic costs of living. They can no longer afford the outsized car loans that banks so generously extended during the boom.

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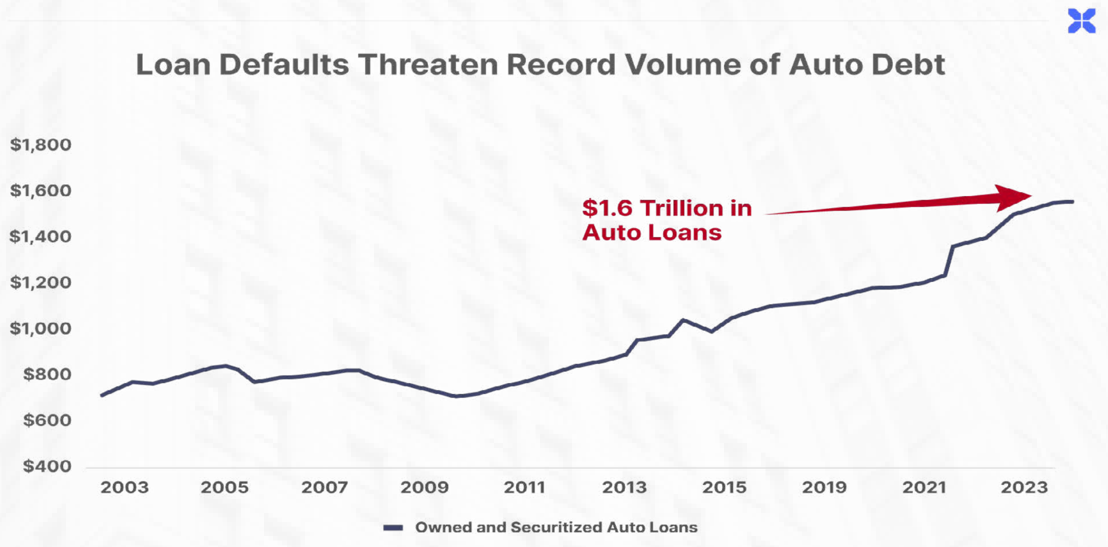
As Lucky Lopez reports, he routinely sees consumers living on $2,500 a month carrying a $1,000 per month car payment. This was possible to pull off during the early stages of the stimulus bonanza in 2020 - 2021. But now, with stagnant wages and spiking inflation, it's impossible.
Data from Fitch Ratings shows default rates have surged to the highest levels since 1996. 6.11% of subprime car loans were delinquent in 2023, compared 0.28% for prime car loans.

Meanwhile, repo companies are buying up vacant car lots to capitalize on the huge numbers of repossessions. And remember those banks who made loans at 140% of vehicle value during the boom?

Lopez reports seeing recovery rates as low as 70 cents on the dollar at recent auctions. That's a 50% haircut. And we're still in the early innings.

One of the secrets on Wall Street this week: The stakes are high. A record $1.6 trillion in debt is at risk from the coming meltdown in America's auto loan market:



Source: St. Louis Fed

Hundreds of billions of dollars could go up in smoke. Of course, this won't be a repeat of the 2008 mortgage crisis. Auto loans pale in size compared with the real estate market.

But it's just one example of the massive scale of capital misallocation that occurred during this market cycle. We could soon see trillions of dollars in paper wealth evaporate, creating devastating ripple effects throughout the economy and financial markets.

In fact, it's already playing out in front of our very eyes...

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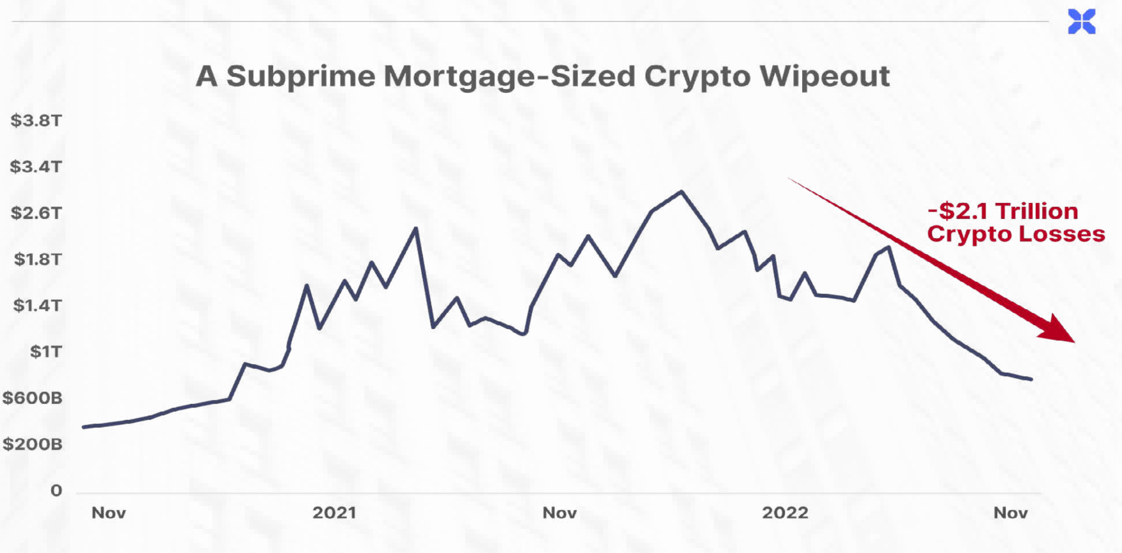
Reverse Wealth Effect

Take cryptocurrencies. At its zenith in November 2022, the total crypto market capitalization reached a mind-boggling $3 trillion.

Fast forward just eight months later to June 2023, and over $2 trillion of paper wealth had evaporated from the crypto market. For a frame of reference, the total value of all subprime loans was only $1.3 trillion at its peak in 2007.

Though things have shifted with Bitcoin and other leading cryptos, we witnessed a subprime-sized implosion in cryptocurrencies alone during the first half of 2022:



During the crypto boom, soaring asset prices produced a powerful wealth effect that trickled down to all areas of the economy. With the crypto bust, a *reverse* wealth effect took hold.

Take for instance the “Rolex index” – a time series tracking of high-end watches. After enjoying a surge in prices alongside inflating asset valuations in recent years, high-end watch prices began rolling over as the liquidity tide recedes:

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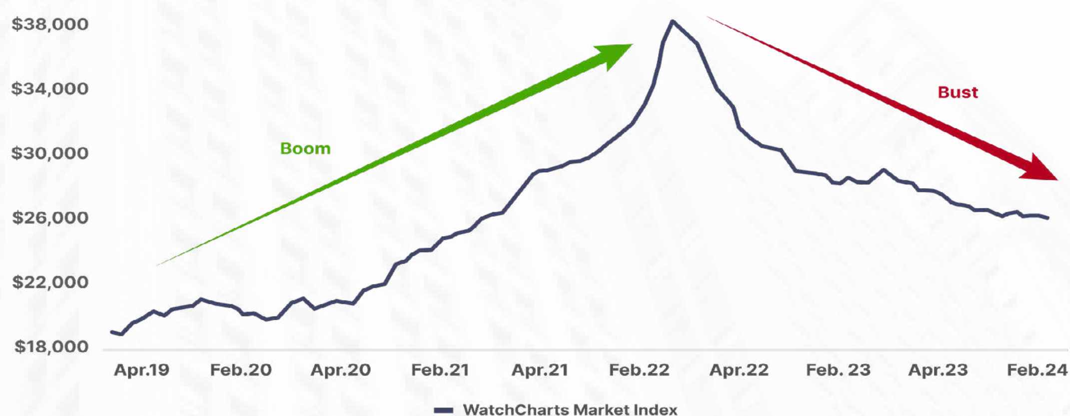

Looking beyond asset prices, we also see clear warning signs in the economic indicators pointing toward a recession...

A Late Cycle Economy on the Brink of Recession

Late cycle economic expansions follow a familiar playbook, where previously loose monetary policy pushes up commodities prices and inflation, forcing the central bank to tighten monetary policy. As the Fed raises rates, the spiking U.S. dollar and higher borrowing costs puts downward pressure on consumer incomes and corporate earnings.

We saw this same pattern precede each of the prior recessions and bear markets.

In the lead up to the dot-com bust, oil prices tripled from $11 per barrel in December 1998 to $37 by September of 2000. The Fed started raising rates, the dollar spiked, and the dot-om recession and bear market was in full swing by early 2001.

Likewise, commodities rallied across the board in the lead up to the 2008 Great Financial Crisis. Oil famously ran to all-time highs of $147 per barrel in June 2008, exerting tremendous pressure on consumer incomes at a time when the economy was already contracting.

In the summer of 2008, Wall Street and the Federal Reserve were fixated on inflation as a key economic threat. Of course, we all know what happened next... the global economy was less than three months away from plunging into one of the greatest deflationary busts of all time.

But for those paying attention, the writing was on the wall as far back as 2007.

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A full 18 months before the Great Financial Crisis, subscribers to the *Stansberry's Investment Advisory* received the following warning in **December of 2007:**

> *"With another 2 million homeowners facing higher interest resets on their adjustable-rate mortgages, it seems that the total number of defaults is going to keep climbing. And that's trouble... I now believe our country's mortgage crisis will spill over into the general economy."*

In that same issue, subscribers received the following advice...

"This is a time to be extremely cautious with your own finances. I believe the S&P 500 will fall this year, by more than 10%. Most stocks will probably decline this year. Thus, simply holding cash isn't a bad strategy right now – your cash will probably outperform your stocks in 2008. Also, I think you should consider hedging your portfolio with some short sales – even if you've never done so before."

And again, the following warning was issued in **March 2008...**

> *"With the S&P 500 down 24% from its peak to its recent trough, we are in the midst of a real bear market. My belief today is stock prices – on average – are going to go lower. Perhaps even much, much lower... I don't think we've seen the 'throw in the towel' moment."*

Finally, there was the call to short Fannie and Freddie on their way to zero, in the **May 2008** issue:

> *"Fannie Mae and Freddie Mac, the two largest and most leveraged owners of U.S. mortgages are sure to go bankrupt in the next 12 months. Congress may decide to assume their liabilities, to prevent an unprecedented global financial calamity, but Congress won't bail out the firms' shareholders... I recommend you sell an equal amount of each stock short."*

While we're not calling for another financial crisis today, we do see signs of epic economic distress and a recession looming on the horizon.

Which for you – it's great news.

Let us explain. First about that pain...

In addition to the distress in the subprime auto market, consumers have taken on record levels of credit card debt to counter the cost-of-living crisis. In the wake of the COVID stimulus bonanza, consumers initially used the extra funds to pay down credit card debt. But this trend reversed in early 2021 when the stimulus money stopped flowing and inflation picked up.

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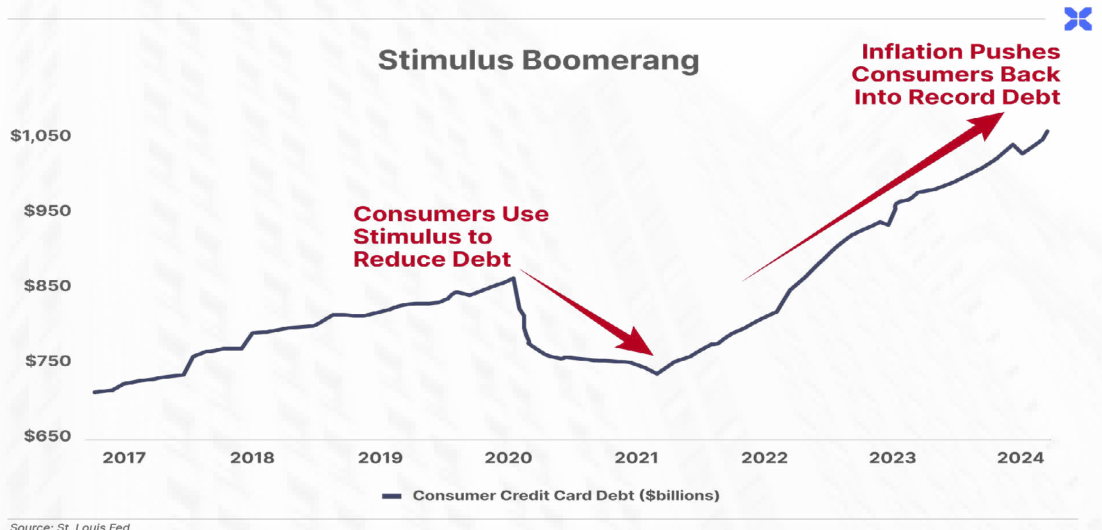
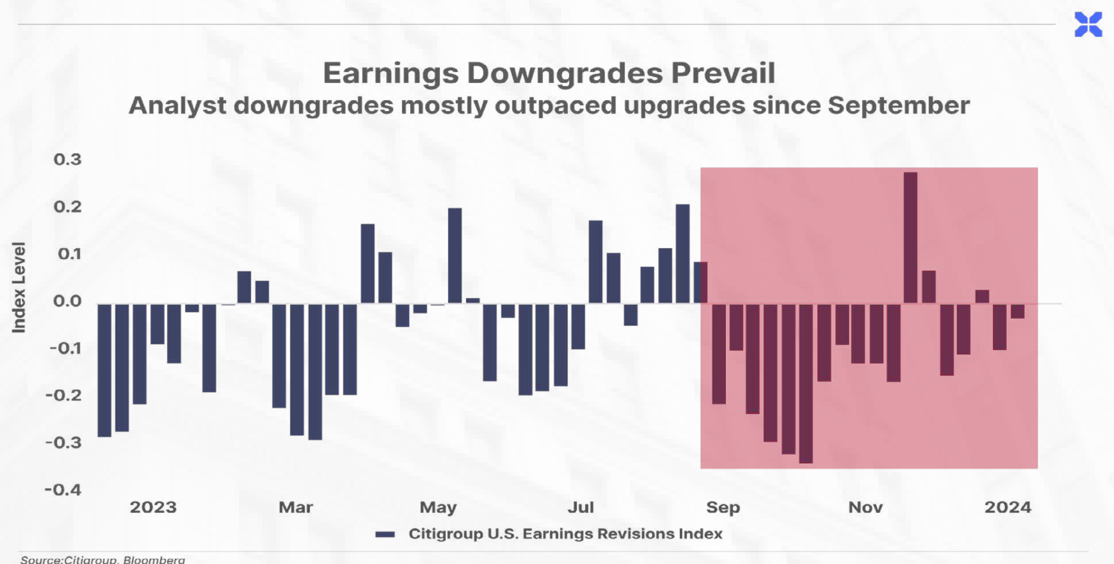
In the last few years, consumers have become saddled with a record amount of high interest credit card debt:



Source: St. Louis Fed

This sets the stage for a coming wave of defaults, and lower consumption, as the economic downturn accelerates.

It's only a matter of time before today's weak consumer activity shows up in corporate earnings. Already, analysts have been busy downgrading their estimates for the upcoming year. As you can see, the market appears to be pricing in an imminent hit to corporate earnings, with downgrades outnumbering upgrades:



Source:Citigroup, Bloomberg

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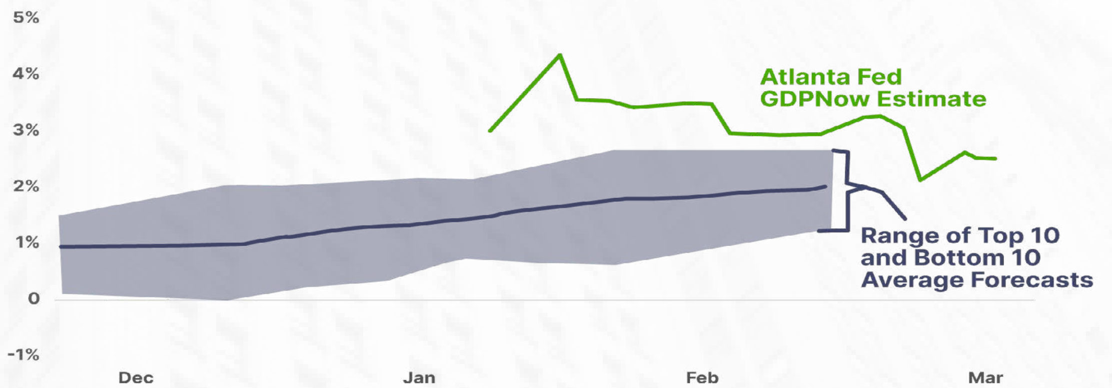
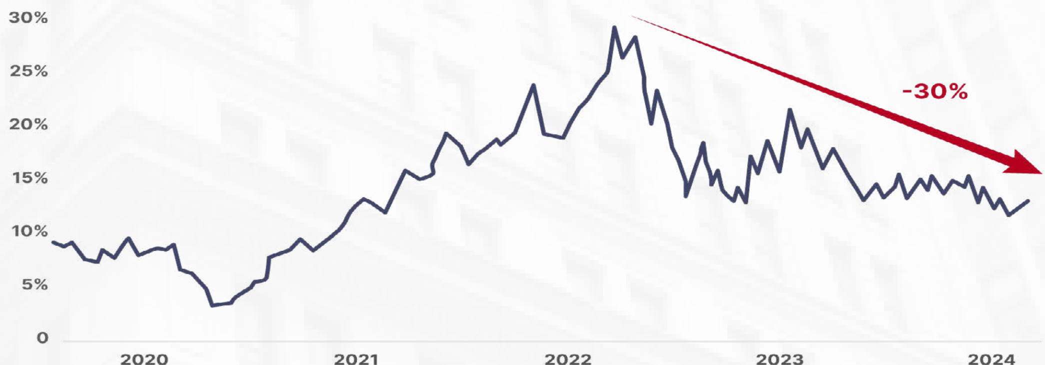
Of course, Wall Street economists have so far brushed off the bad news and currently are revising forecasts for a soft landing or to miss a recession. But the indicators we track show little to no signs of improvement, including the real-time GDP forecast from the Atlanta Federal Reserve:



Finally, there's one of our favorite economists: Dr. Copper, along with other key base metals like aluminum, which provide reliable leading indicators as key material inputs throughout the economy.

Base metal prices have fallen across the board over the past year, approaching levels last seen in 2021 – back when the global economy was struggling to emerge from COVID lockdowns:



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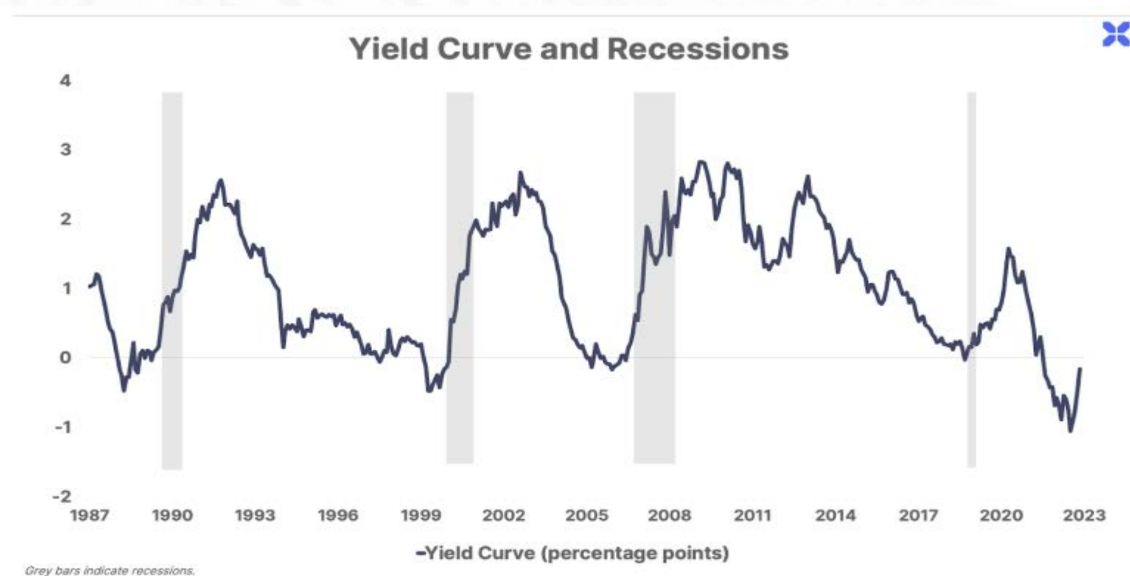
And it's not just base metals putting up warning signs. The single most reliable indicator of an upcoming recession is flashing bright red: *the Treasury yield curve*.

The spread between the 10-year and 2-year Treasury yield has inverted before every recession since World War II. That's why the following chart should put all investors on edge, as the yield curve officially inverted in July 2022:



So, here's the bottom line in all this...

Though on the decline, the most inflation in over 40 years has crushed consumer incomes, forcing the Fed into an aggressive rate hiking cycle, which is just starting to ease. Defaults are spiking while leading economic indicators have turned down across the board.

There aren't many more boxes left to check for a late cycle economy transitioning from boom to bust.

So, what does this mean for you and your money?

Well, remember that great news we mentioned?

When an economic storm of this magnitude hits – that's when you get generational opportunities to buy world class businesses at fire sale prices.

Warren Buffett explains it best:

> *"Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold."*

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In this issue, we're taking our cue from the world's greatest wealth compounder – Warren Buffett. We'll quickly revisit Buffett's incredible long term track record. Along with the secrets that made it possible.

Then we'll share with you a list of our own Buffett-style, world dominating businesses.

These are hand-picked companies that meet our strict criteria of capital efficient, world-class brands with pricing power and impenetrable moats. We've put them on our "bear market buy list" as stocks we hope to buy at fire sale prices when the bear market kicks into high gear.

But first, let's step back and understand exactly what it is about Buffett's style that makes his track record so great.

The World's Greatest Wealth Compounder

Any fund manager can have a great month, great quarter, or even a great year. The legends are the ones who can do it for decades.

That's where Buffett really shines.

Quantitative investment firm AQR shows this by zooming out and ranking Buffett's Berkshire performance against fund managers and common stocks that have existed for at least 10, 30, and 40 years.

The data shows Berkshire ranks #1 among all funds that have existed for at least 40 years. It also ranks #1 out of the 1,111 public stocks that have existed for at least 40 years:

Buffett's Performance Relative to All Other Stocks and Mutual Funds, 1976 -2017

	A Sample Distribution of Sharpe Ratios					Buffett Performance	
Stock/Fund Measure	Number of Stocks/ Funds	Median	95th Percentile	99th Percentile	Maximum	Rank	Percentile
All funds with at least 10- year history	2,872	0.39	0.62	0.74	0.99	11	99.7%
All funds with at least 30-year history	432	0.38	0.59	0.73	0.93	3	99.5%
All funds with at least 40-year history	186	0.33	0.53	0.63	0.79	1	100.0%
All stocks with at least 10-year history	9,523	0.28	0.57	0.75	1.12	57	99.4%
All stocks with at least 30-year history	2,021	0.32	0.52	0.61	0.81	2	100.0%
All stocks with at least 40-year history	1,111	0.34	0.50	0.55	0.79	1	100.0%

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Simply put, there's been no better (public) place to put money than with Warren Buffett over the last 40 years.

$1,000 invested in Berkshire Hathaway in October 1976 grew to more than $3.6 million by March 2017. And all you had to do was buy and hold Berkshire common stock.

The paper notes that one key factor behind Buffett's success was his ability to "stay the course" whereas others may have been forced out of business due to temporary periods of poor performance (such as when Buffett lagged the S&P 500 during the late 90s tech boom).

He achieved this by structuring Berkshire as a corporation with a permanent source of cheap capital. Which introduces the next secret to Buffett's track record…

Dirt Cheap Leverage

AQR's analysis breaks apart Buffett's alpha into two components: leverage and stock picking.

The paper estimates Buffett's average leverage between 1.4x and 1.7x.

The first notable thing is the ultra-low cost of this leverage, thanks to his use of insurance "float" as a cheap source of borrowing. AQR estimates Berkshire's cost of insurance float over the sample period came in at just 1.72% or about 3% below T-bill rates.

Compare that with your average fund manager (or corporation) that likely pays some rate above T-bills to borrow money. This alone explains a non-trivial amount of Berkshire's historical alpha.

The paper also notes another source of cheap financing – Berkshire's ability to finance capex with tax deductions through accelerated depreciation, which acts like an interest free loan. The paper cites $28 billion of deferred tax liabilities in 2011 from accelerated depreciation.

Finally, the AQR analysis also notes Berkshire sells put options on stock market indices – basically another form of insurance underwriting, where you receive upfront cash in exchange for agreeing to buy a stake in American businesses in the future at a discount.

In summary, through insurance underwriting and tax advantages, Buffett secured billions in ultra-low-cost financing over the years. One illustration cited for the low financing rates Buffett enjoyed was the fact that Berkshire issued the "first ever negative-coupon security in 2002."

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Of course, leverage alone doesn't explain all the outperformance. The paper notes that if you apply the same 1.7x leverage to the broader stock market, it only generates an average excess return of 12.7% (i.e. 12.7% above the rate of T-bill returns), compared with Berkshire's average excess return of 18.6%.

To explain the rest, we go to point number four – *Buffett's stock picking ability*.

Buy High Quality Stocks at Attractive Prices

The paper breaks down the performance of Buffett's public securities and uses a proxy measurement to estimate the performance of privately held Berkshire securities.

The first notable finding is that Buffett's public stocks outperformed the estimated performance of private companies. This implies Buffett's skill mostly comes from his stock picking ability – not from influencing management teams.

From there, the factor analysis indicates that Buffett does not generate any excess returns from the alpha associated with small stocks – as Berkshire favors large-cap stocks. The factor analysis also shows Buffett gets some excess returns from buying "cheap" stocks – but this is not the primary alpha generator.

Instead, the paper shows what many academics have missed historically: that most of Buffett's stock picking alpha comes from *simply buying safe high-quality stocks at reasonable prices*.

We have studied Buffett's letters extensively for the past 25 years – all of them. As far as we know there is no better or more practical guide, anywhere, to understanding rational investing. It was Buffett who taught us about capital efficiency and how it can confer a truly unbeatable advantage to any investor wise enough to seek it out and patient enough to exploit it.

We believe anyone can learn to invest like Warren Buffett, and that's the inspiration for today's issue...

Building Your Own Berkshire Quality Portfolio

Buffett is normally extremely reticent to offer any specific investment advice, but he broke with tradition in his 1996 missive. In this letter, and only in this letter, he addresses individual investors explicitly and offers specific advice on building a portfolio.

> *"Should you choose to construct your own portfolio, there are a few thoughts worth remembering... Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years*

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> *from now. Over time, you will find only a few companies that meet these standards - so when you see one that qualifies, you should buy a meaningful amount of stock... Though it's seldom recognized, this is the exact approach that has produced gains for Berkshire shareholders."*

– Warren Buffett, 1996 Letter From the Chairman

Buffett describes these kinds of businesses as "Inevitables." They are businesses whose competitive advantages are so obvious and entrenched it is hard to imagine even a well-financed competitor making much of a dent in their margins.

As Buffett wrote:

"Companies such as Coca-Cola and Gillette might well be labeled 'The Inevitables.' Forecasters may differ a bit in their predictions of exactly how much soft drink or shaving-equipment business these companies will be doing in 10 or 20 years... In the end, however, no sensible observer - not even these companies' most vigorous competitors, assuming they are assessing the matter honestly - questions that Coke and Gillette will dominate their fields worldwide for an investment lifetime. Indeed, their dominance will probably strengthen. Both companies have significantly expanded their already huge shares of market during the past 10 years, and all signs point to their repeating that performance in the next decade."

– Warren Buffett, 1996 Letter From the Chairman

Twenty-five years later, we can tell you, from direct experience, competing with Gillette is exceptionally difficult. Porter Stansberry has invested almost $10 million over the past decade in developing a high-tech, single-blade, safety razor (www.onebladeshave.com). Despite offering a premium razor with significantly better materials (316L steel, military grade PVD coatings), innovative design (that's patented) and revolutionary functionality, OneBlade isn't yet even remotely a threat to Gillette.

As for Coke, in the 25 years since Buffett wrote his "Inevitables" letter, the company sold almost $800 billion worth of soft drinks, generating cash profits of nearly $200 billion – earning $0.23 in cash for every dollar of products sold.

The company did so while increasing its dividend every year (last year by 17%!) and paying out over $100 billion in total, while also reducing outstanding shares by 12%.

Even now, 25 years later, nothing approaches Coke's global dominance in non-alcoholic beverages. The company still has a 25% net income margin, with double-digit returns on assets and invested capital. It's annual returns on equity are almost always above 40%. As a business, it is a steamroller.

That is, of course, why Coke's shares rarely trade at a reasonable price. Buffett bought his enormous stake in the fall of 1987 after the market's crash, buying for

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around 10 times earnings. The opportunity was so big he put 25% of Berkshire's entire portfolio into the stock.

Normally, businesses like this trade for a hefty premium... and for good reason. High returns on invested capital and a wide moat insulating their businesses from competition means that inevitables can out-earn and out-return the average stock by a mile.

But every once in a while, an outside event – like a financial panic or recession – provides the rare opportunity to buy quality merchandise at fire sale prices...

We believe such an opportunity is on the horizon. And we want to be prepared to act.

That's why we've spent the last few weeks combing through the data and creating a unique quantitative screen to filter for capital-efficient companies with high profitability and high returns on invested capital.

We then further filtered down the list based on a qualitative view of the business's competitive position and durability of its competitive moat.

From more than 10,000 available public securities, we've narrowed the list down to just 15 of the best businesses in the world.

Here's what we found...

The Best Businesses in the World

In the table below, we've compiled a list of 15 businesses that we believe qualify as Buffett-style "Inevitables" - high margin, capital efficient businesses that their current valuations on a price-to-earnings (P/E) and enterprise value to free cash flow (EV/FCF) basis:

Buffett-Style "Inevitables"
as of March 11, 2024

Name	Ticker	Operating Margin	10-Yr Avg Sales Growth	Free Cash Flow Margin	P/E Multiple	Return on Invested Capital (ROIC)	ROIC (10-Yr Avg)
Philip Morris	PM	35.5%	1.6%	22.4%	17.2	22.1%	36.9%
Home Depot	HD	14.2%	9.7%	11.8%	24.5	31.1%	32.2%
Google	GOOG	27.4%	45.0%	22.6%	23.3	24.8%	16.2%
Starbucks	SBUX	16.5%	12.2%	12.0%	24.9	29.5%	23.9%
Apple	AAPL	30.8%	10.8%	27.7%	26.9	57.8%	31.7%
Moody's	MCO	37.6%	9.0%	31.8%	42.8	18.4%	26.7%
Nike	NKE	11.8%	9.2%	12.2%	29.7	18.6%	22.3%
Microsoft	MSFT	44.2%	15.3%	29.6%	36.6	26.4%	20.7%
Hershey	HSY	24.2%	3.6%	13.9%	19.1	23.7%	22.8%
S&P Global	SPGI	42.8%	16.1%	28.5%	41.6	6.2%	28.1%
Domino's	DPZ	17.9%	14.8%	10.8%	30.3	59.0%	75.8%
Nvidia	NVDA	55.1%	183.2%	44.4%	71.6	72.4%	26.2%
Adobe	ADBE	35.1%	40.5%	35.8%	46.5	25.5%	18.1%
Clorox	CLX	14.9%	5.2%	10.0%	34.5	14.4%	24.3%
Sherwin-Williams	SHW	16.0%	11.4%	11.4%	35.3	16.6%	20.6%

Source: Bloomberg

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In a perfect world, we could purchase stakes in these businesses at mid-teens earnings multiples, or lower. Of course, for that to happen, many stocks on this list would need to decline by 30%, 40%, or even 50% *from here*...

That's the kind of "raining gold from the sky" opportunity we can hope for over the coming months.

A Textbook "Inevitable" Stock

Warren Buffett once made the perfect case for owning tobacco stocks...

> *"It cost a penny to make. Sell it for a dollar. It's addictive. And there's a fantastic brand loyalty."*

Of course, that was in the 1980s - before the rise of snowflake capitalism and things like ESG investing.

Today, Buffett shuns tobacco companies because of the negative stigma associated with owning them. It's just not worth the reputational risk, from his perspective.

The good news for you – the individual investor – is that you're not burdened with investing mandates or maintaining a "personal brand." You enjoy the luxury of investing in the best money-making ideas, period.

For now, the key thing to remember is that Big Tobacco has always been in the crosshairs of regulators. And the truth is, you can't understand the business of Big Tobacco without understanding the key role the government plays in their business model. To show how it all works, we must rewind the clock back to the late 1990s...

The Assault on Big Tobacco

In the mid-1990s, the attorneys general of nearly every state and territory in the union banded together in a regulatory assault against big tobacco. Their argument was simple – a growing body of medical data revealed a clear link between cigarette consumption and deadly diseases, like cancer and emphysema. The consensus estimates said that tobacco products were responsible for roughly half a million American deaths each year.

The attorneys argued that tobacco makers should be liable for the public-health burden created by their tobacco products. After a lengthy legal battle, the courts settled the issue via the 1998 Master Settlement Agreement ("MSA"). On the surface, the MSA looked like a death blow to Big Tobacco.

First, let's acknowledge the one key successful outcome from the MSA, at least in terms of its impact on public health. The ruling did manage to prevent new

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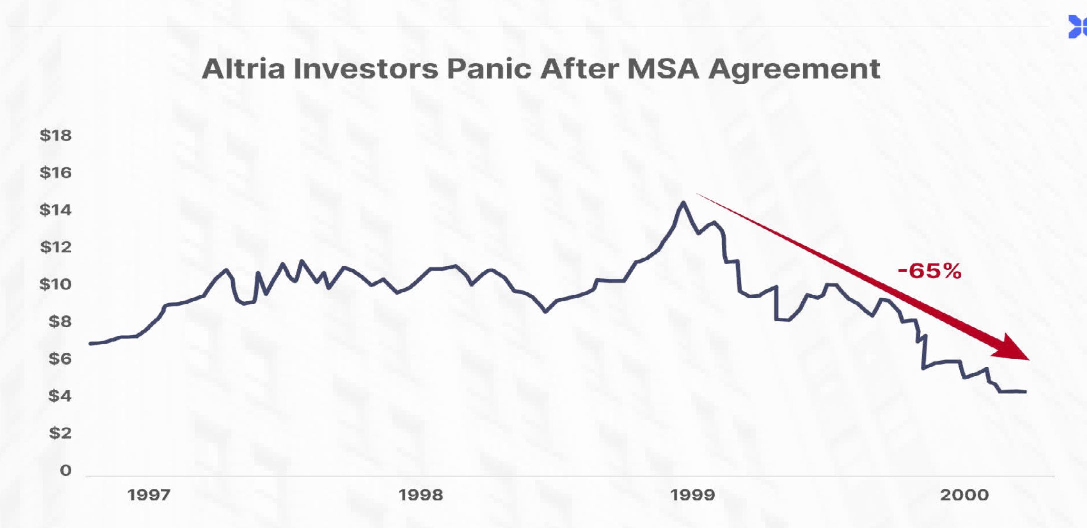
customers from getting hooked on tobacco. That's because the MSA prevented the industry from new advertising and marketing campaigns (can you remember the last time you saw a cigarette ad?)

This, along with broader awareness of the harm caused by tobacco, pushed U.S. cigarette sales into secular decline starting in the late 1990s. (We'll talk about what this meant for the bottom line for Big Tobacco.)

The other key impact of the MSA was saddling the largest four U.S. cigarette makers with over $200 billion in fines over the next 25 years (plus billions in fines thereafter). It was the single largest fine ever levied on an industry up to that point.

Investors panicked on the initial news, selling tobacco stocks across the board. Shares of Altria, for example, which existed as Phillip Morris at the time, collapsed by more than 60% from a high of $14 per share in November 1998 to under $5 per share by March of 2000:



But those who sold on the settlement news got it dead wrong. Altria went on to become one of the best-performing stocks in the market following the MSA deal. From the lows in March of 2000, shares of Altria turned a $10,000 investment into an incredible $400,000 windfall by mid-2017.

Compare this with the S&P 500, which would have turned $10,000 into roughly $25,000 over the same period. Altria wasn't the only big winner – American tobacco companies as a sector beat the market by a wide margin after the MSA dust settled.

How could an industry saddled with hundreds of billions in fines, plus a total chokehold on marketing and advertising, become one of the best performing sectors in the stock market?

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As always, the devil is in the details.

If you ignored the headline hype and simply looked at the mechanics of the MSA, you'll see why Big Tobacco loved Big Regulation. Here's how it worked...

Regulatory Crackdown Creates Regulatory Moat

The MSA set up a formula for American tobacco companies to pay public health "damages." The damages calculation was not based on any kind of analysis of public health cost/benefit. Instead, the formula was based on the level of price increases cigarettes companies could impose on their customers, without sustaining a significant loss in sales.

The attorneys general figured out that they could extract a massive, hidden tax on consumers through tobacco companies that would show up in the form of higher cigarette prices. Here's how it worked...

A key component of the agreement contained a clause stating that, if the combined big four tobacco companies lost more than 2% market share, then the damages that company owed would decline by three times the percentage market share loss beyond the 2% threshold.

While it may sound a bit complicated on the surface, the end goal was crystal clear: locking in the existing market share for tobacco companies, while extracting a hidden tax through higher cigarette prices. It was a total victory for Big Government and Big Tobacco.

So long as tobacco prices went up across the board, Big Tobacco could make more money each year while also paying out "damages" to the government – all at the expense of the average tobacco consumer (who sadly had no high-paid layers on their side during the negotiations.)

And get this: The agreement effectively prevented any new entrants from coming into the market and competing with the big boys from that point forward. How?

Well, the law didn't technically force all other U.S. tobacco makers to sign the MSA. But any tobacco company that did not sign the MSA would still be required to set aside potential damages, proportionate to their volume of cigarettes sold, into an escrow account for 25 years. The regulatory rationale said these funds would satisfy any potential liability that might arise from future legal actions.

So, without forcing all other tobacco companies from participating in the MSA, the end result was the same – it forced all tobacco makers to pay damages in a way that favored the existing market share structure.

Furthermore, if a non-signatory tobacco company decided to sign the MSA agreement at any point in the future, it could avoid setting aside the potential

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damage payments into the escrow account.

But there was a catch...

Any new signatory would only be allowed to increase their market share up to 125% of its 1997 level.

How unfortunate for the potential new tobacco upstart that the Big Four tobacco makers already owned 99% of the market in 1997. This includes the big winner in the MSA dealings – Altria – who owned 50% of the market at the time.

So, if you ever wondered why you haven't seen a major new U.S. cigarette brand on the shelves in 25 years, now you know why.

The 1998 MSA legislation transformed the U.S. tobacco industry into a de facto cartel.

Despite U.S. smokable tobacco volumes entering secular decline starting in the 1990s, the MSA was the single greatest gift anyone could have given the tobacco industry. The agreement single-handedly closed the market to new entrants, locked in market share for the existing players, and eliminated the need to wage expensive marketing/advertising campaigns.

With a customer base that was already hooked on the product, tobacco companies – which were already some of the best businesses in the world – enjoyed a tremendous uplift in their capital efficiency.

How do we explain this?

With the threat of losing market share all but gone - thanks to the structure of MSA payments – U.S. tobacco makers fearlessly raised their prices.

Meanwhile, tobacco makers slashed their operating costs and capital expenditures. After all, they no longer needed to advertise their existing products or invest in new ones, thanks to the MSA deal.

Philip Morris as the Great Alternative

Up until March 2008, Philip Morris was a subsidiary of parent company Altria (NYSE: MO).

Headquartered in Richmond, Virginia, Altria is the leading U.S. tobacco maker. The company's core cash cow is the iconic Marlboro brand in the U.S. (Philip Morris owns the international rights to Marlboro following its 2008 split with Altria).

Along with a handful of other brands, Altria owns roughly 50% of the market for smokable tobacco in the U.S. These "smokable" tobacco products generate about 85% of the company's operating income. The remaining 15% comes from Altria's

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oral segment, including the two leading U.S. category brands – Copenhagen and Skoal – which represent about 40% of the U.S. market.

Also, in late 2018, Altria purchased a 35% stake in Juul Labs as part of its entrance into the "vaping market" - a form of smokeless nicotine consumption, designed to be less harmful than traditional cigarettes. Therein lies the source of Altria's recent regulatory struggles.

The two companies split, based on the idea that Philip Morris could focus on growing the Marlboro brand internationally, while Altria concentrated its efforts on the domestic market.

The move also made good legal sense. Given the tremendous power regulators exert over the domestic U.S. market, making Philip Morris a foreign company would protect the iconic Marlboro brand on the international stage, even if Big Tobacco came under fire again from U.S. lawmakers.

As the two companies went their own ways, Philip Morris invested heavily in a suite of so-called "reduced risk products" RRPs over the last decade.

We recommended Altria to readers in July 2022 at a price of $41.63 and recommended selling it in November 2023. After dividends, the traded amounted to a 12.35% gain over 16 months.

The decision to sell Altria was not taken lightly. With 44% FCF margins and a 39% return on capital, it's historically been one of the greatest and most capital efficient businesses of all time.

The problem is that Altria only looks great when viewed through the rearview mirror. The company's future remains heavily tied to traditional tobacco consumption, and that business is dying.

Big Tobacco is transforming into Big Nicotine. The winners will be those companies with the best smoke-free tobacco alternatives. This includes vaping devices (which vaporize a nicotine-containing liquid for inhalation), oral nicotine pouches, and "heat not burn" products, like the **Philip Morris (NYSE: PM)** IQOS device.

Our original bullish thesis on Altria was based on the view that it would successfully tap into this new smoke-free trend. We also believed that, even as the volume in its combustible tobacco business declined, higher prices would offset these fewer units sold.

We decided to sell the shares from the portfolio when it became clear that both of these assumptions were no longer valid.

After failing to develop its own successful vaping device, Altria paid a staggering $12.8 billion in 2019 to acquire the leading U.S. vape maker, Juul. At the time, Juul held 75% of the U.S. vaping market share. But after coming under fire for its

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aggressive marketing to underage consumers, its business has been hobbled by a regulatory crackdown.

This provided an opening for British American Tobacco's vaping product, Vuse, to take the lead. In the U.S. vaping market, Vuse has risen from single-digit market share in 2019 to 42% today. Meanwhile, Juul's share is in free fall, hitting 25% in 2023 and still declining. Altria has since written down the value of its Juul investment to just $250 million.

Altria hasn't fared much better in the oral nicotine pouch segment. The company's on! Brand of nicotine pouches remains a distant second place to Phillip Morris's Zyn brand, which holds 77% U.S. market share.

As a result, Altria's smoke-free segment remains a minority contributor to sales – making up just 13% of revenue last year. And this segment is not growing enough to offset the rapid declines in Altria's legacy business.

For the last two decades, Altria has raised prices enough to more than overcome volume declines in its combustible tobacco business. More recently, as these volume declines have accelerated, Altria can no longer raise prices fast enough to compensate.

Last year, Altria's combustible tobacco segment posted a revenue decline of 2.4%. Without enough offsetting growth in its smoke-free portfolio, Altria's overall revenues declined 1% last year.

We believe there's still a chance that Altria will eventually figure out the right smoke-free strategy. If it does, we may revisit and change our tune. But as things stand today, an investment in Altria remains a speculative proposition.

The easy, no-brainer bet in this industry is clear: Philip Morris.

The company's IQOS and ZYN products are the two best-selling smoke-free nicotine products in the world. It's been the most successful of all tobacco companies in transitioning its business model, with 39% of its revenues coming from smoke-free products.

Meanwhile, Philip Morris is also enjoying more robust tailwinds from its legacy combustibles business. This is thanks to its geographical presence in emerging markets, where combustible tobacco consumption continues growing. As a result, Philip Morris posted 2.3% growth in its combustibles business last year.

With the world's best smoke-free nicotine products, and a resilient legacy tobacco business, Philip Morris grew revenues by 11% last year. And it's on pace for mid-single digit growth for the foreseeable future.

That's why Philip Morris remains our best bet among all of the tobacco stocks.

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Philip Morris: A Forward-Looking Investment

By 2025, the company plans to get half of its revenue from smoke-free products. And within 15 years, Philip Morris believes it will become the world's largest smoke-free nicotine company.

Chief among them is the IQOS device, which heats up specially made tobacco "heat sticks" to a temperature that releases the nicotine of tobacco leaves – without combusting the thousands of additional harmful byproducts.

The company has invested $9.2 billion since 2014, and that bet is starting to pay off. IQOS is the number two nicotine brand in the world, with nearly 18 million daily users, and which currently generates more than 30% of Philip Morris's revenue.

In 2020, the FDA granted Philip Morris the authorization to sell IQOS in the U.S. under the designation of a "modified-risk tobacco product." IQOS is only the second product ever to earn this label, in addition to the General Snus product by Swedish Match (a company Philip Morris is now seeking to acquire – a story for another day). In simple terms, this means that the FDA has ruled that IQOS qualifies as a device that can protect public health, and which can be marketed with the highly coveted "reduced exposure" label.

Philip Morris has agreed to license and sell IQOS through Altria in the U.S., which got off to a great start in 2020. However, a roadblock was thrown up when British American Tobacco filed suit with the International Trade Commission to halt the importation of IQOS products into the U.S. based on a patent dispute.

The ITC unfortunately sided with British American Tobacco in late 2021 and issued a cease-and-desist order for IQOS sales in the U.S. The situation remains unresolved, but here's the bottom line…

The IQOS product has so far avoided the regulatory snafus from a public health perspective that has so far plagued Juul and the broader vaping sector. Plus, IQOS has been a massive international success, and if smokeable tobacco is going to be disrupted, all signs indicate that IQOS will be the disruptee.

Plus, Philip Morris continues investing heavily in a wide range of additional smoke-free nicotine products. This includes vaping products, nicotine patches, and a series of other cigarette alternatives.

That's why we believe Philip Morris offers the ultimate hedge against both Altria's core cash cow smokeable business, as well as a hedge against the broader vaping industry, including Juul.

The financials are robust at Philip Morris. The company enjoys 20% returns on equity, and 40% returns on invested capital, and 40% operating margins. The stock is attractively priced at less than 15x earnings and pays out a well-covered 5.5% dividend.

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And its ownership in the iconic Marlboro brand as well as IQOS puts the company in the leading international position for both smokable tobacco products, plus a potential future of smokeless nicotine consumption.

Action to Take: For the latest updates on our open positions, please visit our live portfolio **here.**

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