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Costco and 5 More Stocks That Can Steer Clear of Target's Mess

By Teresa Rivas Follow Updated June 8, 2022 7:25 am ET / Original June 8, 2022 2:00 am ET

Target is sending the retail sector into a tailspin after reporting its bloated inventory woes.
Joe Raedle/Getty Images

Just last month, Target TGT -2.31% sent the retail sector into a tailspin with its disappointing earnings and forecast. On Tuesday it was a feeling of déjà vu, with yet another guidance cut from the big box retailer weighing on it and its peers.

In the rush to sell, some stronger names were unfairly trampled.

Bloated inventory was the main culprit, as Target (ticker: TGT) is using additional discounts and order cancellations to try to get levels under control. The company's revised outlook is notable because it came just three weeks after already lowered expectations—making investors worry that management is still behind the eight ball. It also hit just days after Walmart WMT -1.20%'s (WMT) investor day, when that company noted that inventory remained elevated but it was able to reiterate—rather than lower—its forecast.

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"Retailers make mistakes and [Target] management just got it wrong," says Eric Wightman, senior wealth advisor and partner with XML Financial Group. "I don't think investors should go out and sell off things like Lululemon Athletica (LULU) and Macy's (M). They're not in the same business and they didn't make the same mistakes."

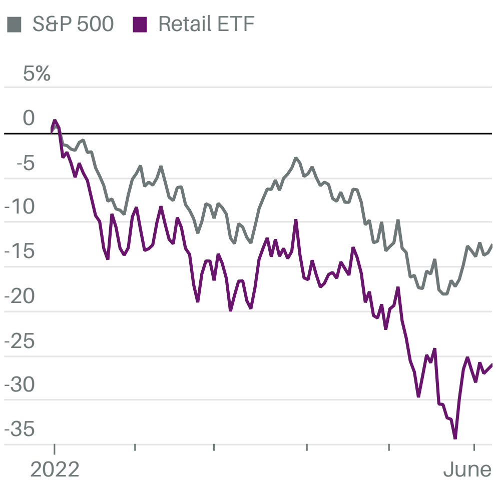
Some headwinds, like rising transportation costs, are nearly universal in the industry, but not all companies are dealing with Target's issues. That means the selloff creates a buying opportunity for investors interested in braving the consumer discretionary sector.

Barron's made much the same point earlier this week, highlighting that there were plenty of retail winners this earnings season as well.

Of course, the worry is that efforts by big retailers to fix their mistakes could reverberate throughout the industry. "There's a prisoner's dilemma," says David Silverman, senior director at Fitch Ratings. "Even if [a retailer] bought an appropriate level of inventory, they may be forced into running unplanned promotions to keep up with competitive activity."

That could present a problem for some already struggling mall staples, like Gap (GPS) and Abercrombie & Fitch (ANF) which also sell basics and casual apparel at a time when consumers have already stocked up on those, and are focusing on dressier attire and athleisure.

Retail stocks have suffered deep losses this year.



Note: SPDR S&P Retail exchange-traded fund.
Source: FactSet

Perhaps one way to pinpoint attractive stocks is to look for those that aren't likely to face a knock-on effect from discounting by the big box players.

Dollar stores immediately come to mind: Dollar General **DG +0.80% ▲** (DG) and Dollar Tree **DLTR +0.30% ▲** (DLTR) both posted robust results last month, and aren't carrying much in the way of apparel. As *Barron's* has noted in the past, they tend to be closer to lower-income consumers trying to limit their miles driven at a time of high gas prices, and have seen success in good economic times and bad.

"The dollar store retailers have performed exceptionally well," says David Barse, founder and chief executive of index company XOUT Capital. "They've proven resilient in up and down environments. You're talking about lower-margin and lower-price merchandise—that's where consumers continue to flock. It's the higher price and margin items that can be a harder sell now."

Indeed, Target specifically lowered its margin outlook on Tuesday, citing the need for promotions. That comes after the company's margins expanded dramatically during the pandemic, notes Wightman. "It's just unsustainable."

Costco Wholesale COST -0.15% ▼ (COST) is another discounter that looks well placed. Its most recent earnings results held up better than the big box retailers, and it's proven to be a best-in-class retailer throughout the pandemic.

Moreover, Costco's business model is different, adding a layer of protection. "Costco really makes money on membership fees; that goes right to the bottom line," says Max Wasserman, founder and senior portfolio manager at Miramar Capital, who also complements the company's management through recent industry headwinds.

He notes that they too deal with lower-margin items like food, and as *Barron's* previously noted, margins are less of a worry for the company, as it builds on customer loyalty.

It's also worth noting that while Target was falling Tuesday on its lower outlook, Tractor Supply (TSCO) was on the rise after doing just the opposite. The farm and ranch retailer, which delivered a better-than-expected first quarter in late April, raised its comparable sales outlook for the current quarter, although several analysts note that its forecast could still be conservative. That was welcome news given that investors have sought out reassurances from retailers after Walmart and Target reset the bar lower in mid-May.

The update was enough to garner praise even from analysts who are sidelined on the stock. “Overall, Tractor Supply’s second-quarter outlook should provide confidence to the market that its trends have remained solid even during a time when several other retailers are beginning to witness a slowdown,” writes UBS analyst Michael Lasser. “This should help support its premium multiple.”

And what about Target itself? Is it a buy after losing a third of its value since the start of the year?

“[I]f you hold your nose and buy here you will probably make money eventually,” notes John Zolidis, president of Quo Vadis Capital.

Miramar’s Wasserman says much the same, arguing that investors should have expected the Target news, given that the company has to clear out inventory to reset for the key fall season, and the next potential catalyst for the stock—back-to-school shopping. “It is a show-me story, but I think in the third and fourth quarter, they will start to show investors” an improvement.

In other words, while fashion sank Target this time around, investors can take a page from its book. Wait long enough, and everything will come back in style.

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