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Aquila & Co. AG | 11. July 2016

Consumer stocks – a key component of equity portfolios

Consumer stocks are long-term outperformers. Some economists suggest that there is little reason to expect sustained outperformance or underperformance from specific sectors on a long-term basis. They point to the argument that high returns on capital attract more capital which in time will depress returns, leading them back towards the mean. Similarly, low returns encourage capital to go elsewhere and, as capital becomes more scarce, returns should go up. This theory is logical enough but conflicts with experience. Some sectors – for example, mining and materials - are serial underperformers, partly because bear markets in commodities generally last much longer than bull markets. In terms of long-term outperformance, two sectors in particular stand out – health care and consumer staples. According to a study published by Fidelity both sectors generated average annualized returns between 13% and 14% in the US over a period of more than 50 years (1962 to mid-2015). The other broad consumer sector – consumer discretionary – did less well. Its 11% annual average return, while higher than that of the overall market, was associated with significant volatility. We believe these US results are relevant for many other markets as well.

Consistently high-return companies are concentrated in consumer industries.
Credit Suisse's Holt unit analyses companies according to the returns they achieve on invested capital. The key metric is the inflation-adjusted cash flow return on operating assets (CFROI). In a study covering nearly 30 years from 1985, they estimate that on average companies generated a return on capital (measured in CFROI terms) of around 6% p.a. The top quartile averaged a return around 11% pa. and were clear "value-creators". The bottom quartile averaged a return around 3% pa. and were clear "value destroyers". Breaking the time series up into five year periods, the study found that just 9% of top quartile firms were in the bottom quartile five years later, while just 6% of the bottom group made it to the 'champions league' within the next 5 years. In other words, winners tended to stay winners and losers to stay losers. Looking at the winners, the study found a remarkable concentration in the consumer industries. Of the 25 sub sectors in the MSCI's industrial sector classification, the top four sectors for "return persistence" were all in consumer industries – household and personal products; food, beverage and tobacco; food and staples retailing and, fourthly, hotels, restaurants and leisure. By contrast 80% of all transitions from the top to the bottom quartile related to businesses in cyclical sectors such as energy, materials and finance.

Consumer companies own franchises which deliver pricing power.
The high returns of consumer-facing companies – or at least the successful ones that dominate stock market indices – reflect the fact that they have valuable franchises. Companies such as Nestle or Unilever have products which attract loyalty and for which customers are consistently prepared to pay a premium. Both of these companies have sophisticated distribution systems in many countries, which have been built up over decades and cannot be easily replicated. Their competitive strengths give them the pricing power to generate superior margins. By comparison, the assets of a mining

company will produce ore bodies of various grades which, depending on price, it will be profitable (or not) to process and sell. Most of the time the mining company will be a price taker, even if it is a major supplier to the market.

Consumer businesses often have less balance sheet risk.
A second factor, which applies especially to consumer staples companies, is that business risk in many consumer industries is relatively low. This is partly because products tend to be small and inexpensive allowing more stable patterns of demand. Furthermore, a new distribution center need not stress the balance sheet of a multinational consumer company. Contrast this with the balance sheet risk of developing major mining projects, which are often extremely expensive, may take years to come to fruition, and where production, when it comes on stream, will often sell for prices far removed from the pricing assumptions that led to those projects being commissioned in the first place. Then there are other industries – such as banking - where balance sheet risk is in a sense the raison d'être of the business. Because of their relatively stable and positive rates of cash flow generation, consumer companies often have little need for external finance, although tax optimization encourages many to take on debt. This reduced balance sheet risk is a source of earnings stability.

Over the long term, consumer staples stocks have delivered the best risk-adjusted returns.
It is not therefore surprising that consumer staples companies tend, in equity terms, to be relatively low risk investments. "iShare" ETFs for US Consumer Goods and for Global Consumer Staples both have betas of 0.71 with respect to the US S&P 500 index. In the Fidelity study covering the US between 1962 and 2015, Consumer Staples showed, among the 10 broad sectors of the MSCI industry classification, the second lowest standard deviation of annual total returns. Only Utilities showed a lower volatility. More concretely, the worst 3 year return for the US Consumer Staples sector in the more than 50 year period since 1962 is -1%. This compares with -16% for the broader US stock market.

With many investors underweight, consumer stocks offer outperformance to investors comfortable with taking a longer-term view.
With outstanding risk-adjusted returns – of the 10 MSCI industrial sectors the second highest return and the second lowest volatility based on US data from 1962 to 2015 – one would expect that many investors would want to overweight the sector. But, actually, many investors are underweight. If one looks at the total of market capitalizations of the 10 US broad industrial sector ETFs run by Blackrock (iShares), just 16% is accounted for by the Consumer Staples and Consumer Discretionary ETFs whereas the percentage of the overall US market that these two sectors combined represent is more than 23%. We believe this underweight, which is replicated in many portfolios, is a reflection of the way in which stable consumer companies tend to outperform. Put simply, they tend to rise by less than the overall market in rising markets, but to fall by much less than the overall market in falling markets. This means that consumer staples can mean serious underperformance when markets are hot, or at times when the average investor is more likely to consider investing in equities. But therein lies the opportunity for investors able to take a longer term view and detach themselves from short term performance indicators. Stable consumer companies should be an essential component of all equity portfolios aimed at generating outperformance over the longer-term.

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