



FISHER INVESTMENTS™ on

CONSUMER STAPLES



- An in-depth look at the global Consumer Staples investment universe including food, beverages, household products, retailers, and more....
- Tips and tools for security analysis and portfolio management
- A useful guide for investing in any market condition

Foreword by *New York Times* best selling author Ken Fisher



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FISHER INVESTMENTS PRESS

Fisher Investments Press brings the research, analysis, and market intelligence of Fisher Investments' research team, headed by CEO and *New York Times* best-selling author Ken Fisher, to all investors. The Press covers a range of investing and market-related topics for a wide audience—from novices to enthusiasts to professionals.

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Fisher Investments on Consumer Staples

Fisher Investments
with
Michael Cannivet and
Andrew S. Teufel



WILEY

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Foreword

You're holding the third in a series of investing guides from Fisher Investments Press—the first ever imprint from a money management firm, produced in partnership with John Wiley & Sons. These guides are your introduction to a usable, top-down strategy for analyzing standard investing sectors (Energy, Materials, Consumer Staples, Health Care, Industrials, etc.) as well as other investing regions and categories. We plan on tackling them all.

Why publish an investing series when, to my knowledge, no other money manager has done it? Simple: It's a logical extension of standard operating procedure at my firm. We place a heavy premium on education—of our clients, of the broader world, and internally of our own employees who we work hard to promote internally. The more we teach, the more we can learn about capital markets, and the faster we can advance our own and others' understanding of how they work. This can only make us all better investors over time.

Consumer Staples is perhaps an underappreciated sector. It's not seen as hot and high growth—but this is a mistake. First, Consumer Staples has both growth and value areas—unusual but not unheard of for an investing sector. Second, it's wrong to think one sector is inherently better or worse than another. Given enough time, finance theory says all investing categories should net pretty similar returns when properly accounted for—though traveling different paths. Consumer Staples is no exception.

Consumer Staples plays a key role for global, top-down investors. Because there's generally inelastic demand for Staples goods and services, it's historically been a defensive

play. This sector tends to hold up relatively well in market downturns, while generally lagging during boom times—but not always! A good investor needs to understand when and why Staples are likelier to lead or lag. Even if you believe Staples are apt to lag, they can still diversify and be a critical counter strategy should your bullish core strategy bets go awry. You'll read more on this in Chapter 7.

An interesting feature about Consumer Staples: Emerging markets good demand for Staples products. (Though whether individual emerging markets emerge or submerge is a separate question entirely, one another impending Fisher Investments Press title, *Fisher Investments on Emerging Markets*, aims to answer.) Currently, in many less-developed economies, demand for Staples is more elastic, meaning the sector there can act more like its cousin, Consumer Discretionary. A good investor must know how and why that happens to make better, forward-looking overall forecasts. This book can teach you how.

Don't look to this book for hot stock tips for 2010, 2011, 2018, or 2035. Any book claiming to provide them is a fairy tale. Rather, this book provides a workable, repeatable framework for increasing the likelihood of finding profitable opportunities in the Consumer Staples sector. And the good news is the investing methodology presented here works for all investing sectors and the broader market. This methodology should serve you not only this year or next, but the whole of your investing career. So good luck and enjoy the journey.

Ken Fisher
CEO of Fisher Investments
Author of the *New York Times* Best Sellers
The Ten Roads to Riches and *The Only
Three Questions That Count*

Preface

The *Fisher Investments On* series is designed to provide individual investors, students, and aspiring investment professionals the tools necessary to understand and analyze investment opportunities, primarily for investing in global stocks.

Within the framework of a *top-down* investment method (more on that in Chapter 7), each guide is an easily accessible primer to economic sectors, regions, or other components of the global stock market. While this guide is specifically on Consumer Staples, the basic investment methodology is applicable for analyzing any global sector, regardless of the current macroeconomic environment.

Why a top-down method? Vast evidence shows high-level, or *macro*, investment decisions are ultimately more important portfolio performance drivers than individual stocks. In other words, before picking stocks, investors can benefit greatly by first deciding if stocks are the best investment relative to other assets (like bonds or cash) and then choosing categories of stocks most likely to perform best on a forward-looking basis.

For example, a Technology sector stock picker in 1998 and 1999 probably saw his picks soar as investors cheered the so-called “New Economy.” However, from 2000 to 2002, he probably lost his shirt. Was he just smarter in 1998 and 1999? Did his analysis turn bad somehow? Unlikely. What mattered most was stocks in general (and especially US technology stocks) did great in the late 1990s and poorly entering the new century. In other words, a top-down perspective on the broader economy was key to navigating markets—stock picking just wasn’t as important.

Fisher Investments on Consumer Staples will help guide you in making top-down investment decisions specifically for the Consumer Staples sector. It shows how to determine optimal times to invest in Consumer Staples, what industries and sub-industries are likelier to do best, and how individual stocks can benefit in various environments. The global Consumer Staples sector is complex, including a handful of sub-industries and many countries, each with their own unique characteristics. Using our framework, you should be better equipped to critically analyze the sector, spot opportunities, and avoid major pitfalls.

This book takes a global approach to Consumer Staples investing. Most US investors typically invest the majority of their assets in domestic securities; they forget America is less than half of the world market by weight—over 50 percent of investment opportunities are outside our borders. Many of the world's largest Consumer Staples firms are based in foreign nations, including several in emerging markets. For those domiciled on domestic soil, a large percentage of sales is often derived overseas. Simply stated, it is vital to maintain a global perspective when investing in Consumer Staples today.

USING YOUR CONSUMER STAPLES GUIDE

This guide is arranged into three sections. Part 1, “Getting Started in Consumer Staples,” discusses fundamental sector basics and Consumer Staples’ high-level drivers. Here we’ll discuss basic tenets of the Consumer Staples sector, including a detailed explanation about the economic notion of elasticity and an introduction to common strategic attributes enjoyed by successful firms operating in the sector. We will also delve into a historical survey of key transition periods that helped shape the modern Consumer

Staples sector. The introductory section of the guide then finishes up with an overview of vital economic, political, and sentiment drivers of the sector.

Part 2, “Next Steps: Consumer Staples Details,” builds on the foundational knowledge from Part 1, opening the door to more granular sector analysis. We’ll take you through the global Consumer Staples sector investment universe and its diverse components. Firms operating in this sector are similar because they tend to be relatively non-economically cyclical, but diverse in scope, including manufacturers from various levels of the supply chain and retailers. We’ll take you through each industry of the sector in detail in explaining how they operate and what specifically drives each industry—so you can analyze the current operating environment and have a rational basis for choosing which industry will most likely outperform or underperform looking forward. Part 2 will also expose you to unique challenges faced by firms operating in the Consumer Staples sector and provide a detailed account of the unique state of consumer products in emerging markets.

Part 3, “Thinking Like a Portfolio Manager,” delves into a top-down investment methodology and individual security analysis. You’ll learn to ask important questions like: What are the most important elements to consider when analyzing Consumer Staples firms? What are the greatest risks and red flags? This book gives you a step-by-step process to help differentiate firms so you can identify those with the greatest probability of outperforming. We’ll also discuss a few investment strategies to help determine when and how to overweight specific sub-industries within the sector.

Note: We’ve specifically kept the strategies presented here high level so you can return to the book for guidance no matter the market conditions. But we also can’t possibly

address every market scenario and how markets may change over time. And many additional considerations should be taken into account when crafting a portfolio strategy, including your own investment goals, your time horizon, and other factors unique to you. Therefore, you shouldn't rely solely on the strategies and pointers addressed here because they won't always apply. Rather, this book is intended to provide general guidance and help you to begin thinking critically not only about the Consumer Staples sector, but investing in general.

Further, *Fisher Investments on Consumer Staples* won't give you a silver bullet for always picking the best stocks. The fact is, the right Consumer Staples stocks will be different in different climates and situations. Instead, this guide provides a framework for understanding the sector and its industries so that you can be dynamic and find information the market hasn't yet priced in. There won't be any stock recommendations, target prices, or even a suggestion whether now is a good time to be invested in the sector. The goal is to provide you with tools to make these decisions for yourself, now and in the future. Ultimately, our aim is to give you the framework for repeated, successful investing.

Acknowledgments

No book is ever the product of just one or two people, and we extend our sincere gratitude to a number of colleagues and business associates for their help in making this book a reality.

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Of course this book would also not be possible without our data vendors, so we owe a debt of gratitude to Thomson Datastream, Thomson Reuters, and Global Financial Data in particular for their permissions. We'd also like to extend our appreciation to our team at Wiley for their support and

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Last, Michael would also like to thank his wife Jennifer, who edited the first copies of this book in their earliest form and probably learned more about the Consumer Staples sector than she ever bargained for in the process. This book could not have been completed without her unwavering love and support.

I

GETTING STARTED IN CONSUMER STAPLES

1

CONSUMER STAPLES BASICS

Joe Consumer has one thing on his mind at 6:10 Monday morning: Coffee. Lulled by the drip of the coffeemaker, Joe idly listens to the news. After his first cup, Joe pours himself some Wheaties—the “Breakfast of Champions.” He stares at the bright orange box, recalling childhood dreams of becoming the next athlete to grace the front. Waking from his nostalgia, Joe quickly showers and shaves. He’s chagrined to discover he’s out of deodorant—his wife’s deodorant is the only alternative. (Hopefully, they mean it when they say “strong enough for a man.”) Next, he brushes his teeth but is bothered by his reflection—his hair is paying homage to Alfalfa. He gels his cowlick and is out the door 10 minutes behind schedule, as usual.

Your morning routine may be similar to Joe’s. The day-to-day items you use and the investment potential inherent in these products are the focus of this book. Coffee manufacturers, food and toothpaste firms, and a host of other businesses all fit into the global Consumer Staples sector.

This book casts a spotlight on the countless investment ideas found in the myriad products you have in your kitchen, bathroom, and workplace. Of the 10 standard investing sectors, Consumer Staples arguably plays the most active role in daily life. Many of the firms making the products you use daily are publicly traded and can be an integral part of your portfolio.

This chapter will highlight some Consumer Staples basics, including what makes some consumer products *staples* and others *discretionary*—particularly focusing on the concept of *elasticity*. We'll also view long-term sector performance trends and analyze a very famous investor's take on Consumer Staples stocks.

OVERVIEW

Each investing sector has a unique set of attributes. The Industrials sector, for example, is generally capital intensive and economically sensitive. The Energy sector is highly dependent on the supply and demand for oil, while the Technology sector is innovation driven, with a degree of economic cyclicalness. So what characterizes the Consumer Staples sector?

Some common characteristics: First, this sector's products have a common end market—consumers. Second, like Joe Consumer, these are products many folks use daily. Finally, frequency of use tends to be consistent for these products, regardless of how the economy is doing.

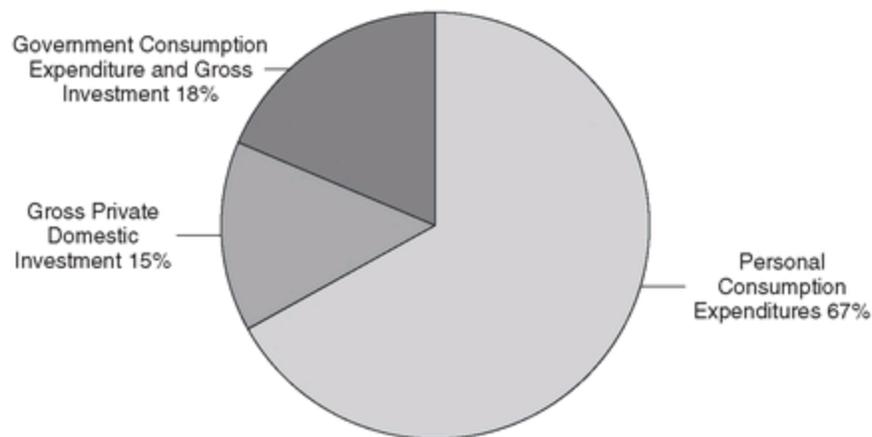
Note: This isn't to say Consumer Staples is inherently superior to other sectors—it isn't. But Consumer Staples, like each sector, has unique attributes leading both to outperformance and underperformance depending on economic and market conditions. There will be periods when Consumer Staples performs very well relative to the broad market and periods when it lags. The aim of this book is to give you tools to help better predict when that happens and why.

A Big Target Market

Relative to some other standard investing sectors, Consumer Staples has a huge target market. Consumer spending represents about 70 percent of the US's gross domestic product (GDP), as shown in [Figure 1.1](#). It's tough to get a much larger target market than selling directly to consumers.

Figure 1.1 GDP Composition Breakdown

Source: US Department of Commerce Bureau of Economic Analysis.



Not only do Consumer Staples firms have vast potential target markets, but the goods they produce can be ubiquitous. Staples products are nearly everywhere—home, work, stores, restaurants, and so on. Purchasing these items is a natural routine of most grocery store trips and can be an automatic decision based on brand familiarity. Finally, consumption patterns for staples—which are generally viewed as basic necessities—tend to be recession resistant and more stable over time relative to other standard investing sectors.

Sector Composition

Consumer Staples can be broken down into three main categories: Food, Beverage & Tobacco (grouped as one category); Household & Personal Products; and Food & Staples Retailers. (Chapter 4 will cover each of these industries and sub-industries in greater detail.) [Table 1.1](#) lists just a few familiar firms and some of their best-known brands, and the 10 largest global Staples firms (by market cap) are listed in [Table 1.2](#).

[Table 1.1](#) Examples of Companies & Products by Industry

Company	Industry	Product
Kraft	Food	Kraft Macaroni & Cheese
Kellogg	Food	Kellogg's Corn Flakes
Nestlé	Food	Nestlé Toll House Cookies
Coca-Cola	Beverage	Coca-Cola Classic
Pepsi-Cola	Beverage	Diet Pepsi
Anheuser-Busch	Beverage	Budweiser
Philip Morris	Tobacco	Marlboro
RJ Reynolds	Tobacco	Camel
Procter & Gamble	Household Products	Tide laundry detergent
Kimberly-Clark	Household Products	Huggies diapers
L'Oréal	Personal Products	Garnier
Estée Lauder	Personal Products	Clinique
Wal-Mart	Food & Staples Retailers	Diversified staples retailing
Kroger	Food & Staples Retailers	Grocery stores
CVS Caremark	Food & Staples Retailers	Drug retailing

[Table 1.2](#) Top 10 Consumer Staples Firms

Source: Thomson Datastream; MSCI, Inc.¹ as of 06/30/2008.

Name	Country	Market Value US\$ (billions)
Wal-Mart Stores	US	\$222.0
Procter & Gamble Co	US	\$184.7
Nestlé	Switzerland	\$174.2
Coca-Cola Co	US	\$120.4
Philip Morris Int'l	US	\$105.1
PepsiCo	US	\$101.4
British American Tobacco	UK	\$67.3
L'Oréal	France	\$64.9
CVS Caremark	US	\$56.9
Tesco	UK	\$56.4

STAPLES' DISTANT COUSIN—CONSUMER DISCRETIONARY

Consumer Staples and Consumer Discretionary are a little like cousins—part of the same general family (consumer oriented), but not much in common beyond that.

Consumer Discretionary firms include automobile manufacturers like General Motors, apparel stores like Gap, national restaurant chains like the Cheesecake Factory, and large entertainment firms like Disney. The primary difference between the two sectors is Staples firms produce goods deemed as necessities (soap, cereal, bottled water), while Discretionary firms produce goods deemed as non-necessities (cars, clothing, laptops). This difference can be examined more critically by comparing them in terms of *elasticity*.

Elasticity

Elasticity is a measure of one variable's sensitivity to a change in another variable. The term references changes in

demand relative to changes in price or income. The concept of elasticity is core to understanding what makes the Consumer Staples sector tick.

Elasticity can be calculated two basic ways:

$$\text{Income Elasticity} = \frac{\% \text{ change in quantity}}{\% \text{ change in income}}$$

$$\text{Price Elasticity} = \frac{\% \text{ change in quantity}}{\% \text{ change in price}}$$

If elasticity is greater than or equal to 1 in either calculation, then the demand curve is considered *elastic*. If it is less than 1, it's *inelastic*.

Consumer Staples products are *inelastic*—necessities purchased by consumers regardless of how their personal economic situation shifts over time. Discretionary products are just the opposite—*elastic*—since income or price fluctuations do materially impact consumer demand.

Income Elasticity How can income and price elasticity drive buying decisions? Back to our friend, Joe Consumer. Joe just got a promotion and a 20 percent increase to his current salary of \$70,000 a year. Joe is excited—instead of just one annual family vacation, he figures they can now afford two per year. Here's how the elasticity of Joe's travel mathematically works out, using the income elasticity equation:

$$\begin{aligned} \text{Income elasticity} &= \frac{(2 - 1) / 1}{(84,000 - 70,000) / 70,000} \\ &= 100\% / 20\% \\ &= 5 \end{aligned}$$

With an elasticity of 5, Joe's travel is highly elastic—like most of the broad population. This means that during strong economic times, when many people see wage increases, travel in general shoots up, positively influencing hotels, rental car firms, and so on. Note these are all Consumer Discretionary industries.

Now let's look at how this raise impacts another aspect of Joe's life—his soda consumption. Joe usually drinks a six-pack of Coke per week. He doesn't suddenly start drinking twice the number of Cokes just because he got a raise. A six-pack per week is still fine. Here's how the income elasticity calculation works in this instance:

$$\begin{aligned}\text{Income elasticity} &= \frac{(6 - 6)/6}{(84,000 - 70,000)/70,000} \\ &= 0\%/20\% \\ &= 0\end{aligned}$$

With an elasticity calculation of zero in this example, Coke (a Consumer Staples product) has an inelastic demand relationship to Joe's income.

Note that most investors are unlikely to run elasticity calculations like this in their day-to-day analysis. Nevertheless, the example serves as a practical demonstration of what makes some goods more elastic than others.

Price Elasticity Price elasticity plays a similar role to income elasticity. A price increase will act as a demand deterrent to consumers of discretionary products because as the price of the product escalates, so does the opportunity cost of buying the product. (*Opportunity cost* is

what you give up to get what you want, whether it's time, money, etc.)

An example of price elasticity in relation to a discretionary product: What happens to Joe's vacation plans if energy costs spike? One obvious result—he must pay more for his family's airfares. Consequently, he may postpone his family trip until prices drop a bit or he might take a cheaper vacation than originally planned.

How does price elasticity figure in relation to one of Joe's favorite Consumer Staples items—Coca-Cola? Increased energy costs affect this too. Since Coke now has to pay more to distribute its products, it will likely raise its prices, just like the airlines. Dollar-wise, however, this price increase has a much smaller impact on Joe's overall budget, so he'll probably keep drinking the same number of Cokes every week.

Elasticity From an Investment Standpoint These examples underscore why Consumer Staples stocks can perform better relatively during tumultuous economic periods: When the economy contracts, wages can come under pressure, diminishing demand for many goods. Inflation is another phenomenon that can impact prices—if prices rise faster than wages can keep pace, demand can decrease.

Both of these have the power to materially diminish demand for products across most sectors (not just Consumer Discretionary). But historically, demand holds up relatively well in the Consumer Staples sector. For this reason, investors often seek “safe haven” here. While sales or earnings might not expand much in an economic downturn, the relative price to earnings (P/E) multiple of the sector often rises as investors begin to place more of a