Intelligent Investing

KINNELL & CO

Banking on Consumer Habits

We finished the last edition by saying "One way of mitigating the possible effects of change on your investments is to identify businesses that sell essential products or services that we can reasonably expect to be similar in 2027 or 2037. Because, as is often said, the more things change the more they stay the same". Over the 20th Century consumers have become the dominant driver of economic growth in developed countries as living standards have risen significantly. When it comes to investments two sectors stand out as beneficiaries of this trend, consumer staples and consumer discretionary.

Consumer staples are essentially all those things we need like cereal, toothpaste, shaving blades, toilet paper etc. Consumer discretionary are the 'wants', new TVs, cars, travel, iPhones etc and the purchase of these is more susceptible to being delayed if economic conditions are weaker but we all still eat breakfast, shave and brush our teeth no matter what the economy is doing. Over time consumer tastes and desires do change and some purchases, like a cup of coffee, are arguably consumer staples rather than discretionary due to our changing habits. The best gauge is whether a recession will cause us to stop spending on an item. Whether a staple or discretionary item the major way that a company earns a strong return on the product is from investing into brands and building brand value so that the average punter will pay more for a Coke than a Pepsi, and more for a Pepsi than a Dr Pepper etc. Brand value in the form of higher prices for products extracted from habitual consumers is what pays dividends.

There are some relatively straightforward questions to answer when trying to identify a company that will likely be selling the same products or services in 2027 or 2037. The first is how likely is it the product or service will still be the same and in demand in 10 or 20 years' time? Breakfast, toothpaste, shaving seem safe bets, what about people eating burgers and drinking Coke, that might be slightly less certain but still likely? A focus on more healthy eating and sugar or fat taxes might be a headwind but if a cure for Type 2 diabetes is found then I'd wager burgers, soft drinks and chocolate bars might go up in consumption. The second question is does the company have a durable competitive advantage that will enable it to continue to earn excess returns over its competitors? Will Coke still command a higher price than Pepsi in 10 or 20 years' time? Will Cadbury & Nestle still be the dominant global chocolate brands? If a company has ticked the boxes to these first two questions, then the third one is does the company have a track record of adapting to challenges with product innovation to stay relevant? Coke introduced Diet Coke, then Coke Zero and is now the third largest bottled water company in the world behind Danone and Nestle with its Dasani brand, and sells almost twice as much bottled water as Pepsi. Gillette, owned by Procter & Gamble, has dominated the shaving blade market for decades and innovated with numerous products that have fought off the threat of electric shavers and entrenched its market position. Brand value also largely insulates Gillette from the constant threat of lower priced razor blades as the company spends some of its excess returns on R&D to come up with new products to hook us on. Of course, nothing is forever, but changes in consumer habits tend to be relatively slow which means they can be identified before they become serious problems and successful companies adapt to changing consumer habits.

Once a quality company has been identified with a stable of quality brands that earn strong and sustainable returns the only remaining question to answer is what is a fair price to pay for that company. No matter how good the company, overpaying for the shares will likely lead to an ordinary return for the investor. Many consumer brand businesses look fully valued at present as they have been a popular place for more conservative investors in recent years but there are pockets of value to be had. Mondelez, the owner of Cadbury, sells for 18 times forecast earnings and appears reasonable value, while Nestle is starting to look a little expensive at 24 times forecast earnings. Both though have a track record of paying a solid and increasing dividend with Nestle's going back many decades.

The companies mentioned above are named to further the discussion. This should not be construed to be personalised advice nor a recommendation to invest in these companies. Please contact Kinnell & Co. regarding how best to take advantage of the trends discussed above.

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