Investment View

We believe a strong representation of consumer companies within a portfolio is appropriate for proper balance. Consumer spending on retail products and services is a huge market, representing about 35% of the U.S. economy. Consumer companies benefit directly from this spending and we believe should be well-represented in a portfolio. We recommend an aggregate weighting of 18% for consumer companies, with 9% in consumer staples (defense) and 9% in consumer discretionary (offense).

Consumer Staples and Discretionary: Own Both for Proper Diversification

We divide consumer companies into two sectors: consumer staples and consumer discretionary. Each sector has distinct characteristics and drivers for earnings, which can result in materially different stock performance over short periods of time as illustrated in Figure 1. In some cases, as in 1999, 2000, 2001, 2005, 2007, and 2018, the return performance for the sectors were opposite each other, highlighting the importance of diversification.

Figure 1 - Returns on Discretionary and Staples Stocks Can Differ Materially in Short Time Periods (Source: Factset; Data as of 9/30/19)

The S&P 500 Consumer Staples Index consists of 33 consumer staples companies within the S&P 500 Index. The S&P 500 Consumer Discretionary Index consists of 63 consumer discretionary companies within the S&P 500 Index. The S&P 500 Index is based on the average performance of 500 widely held common stocks. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

Since predicting which sector will outperform in any given year with consistency is extremely difficult, we recommend clients have exposure to both areas. We suggest using consumer staples companies for defensive positions (which can potentially help reduce downside risk during bear markets) and consumer discretionary companies to position for offense (to potentially help participate in the market's strength during bull markets).
Investing in Staples
- Consumer staples companies make or sell products we need on an everyday basis, such as household products, packaged foods and beverages.
- Staples stocks tend to outperform during periods of economic contraction and underperform when the economy begins to improve.
- Earnings tend to be consistent, but earnings growth can be slower for more mature industries.
- Dividends paid to shareholders tend to be higher and grow more consistently given the availability of cash flow and steady earnings.
- Many companies in the Staples sector have brands that lend themselves well to international markets and have opportunities for growth outside of the U.S.

Investing in Discretionary
- Consumer discretionary companies in the leisure, media and retail industries, make or sell products we want (items we purchase after all our basic needs are satisfied) or buy on a more infrequent basis.
- As a result, consumer discretionary stocks tend to outperform in periods of economic expansion and underperform when the economy is retrenching.
- Sales and earnings growth can be higher because we believe many companies and industries are still in a growth phase and expanding their operations.
- Dividend yields are usually more modest and dividend growth can be lumpy with little to no increases or even decreases during economic recessions and larger increases in economic expansions.
- Many brands of consumer discretionary products and services have international growth opportunities as income levels of households in emerging markets grow over time, leaving room for discretionary purchases.

Identifying Investment Candidates
When trying to determine the best investment candidates from within the consumer staples and consumer discretionary sectors, we apply valuation and fundamental analysis to derive a set of stocks that we believe offer the best opportunities.

We use long-term track records of the S&P Consumer Staples* and Consumer Discretionary* indexes over a long duration as a starting point for our research. We also limit our research to companies that have a minimum of 10 years of operating history, annual sales of $1 billion or more, a market capitalization of $2 billion or more and a credit rating from Standard & Poor's that is investment grade. We then begin the process of identifying what we feel are the most attractive investment candidates from this initial set of companies.

To identify these core investment candidates, we look for companies that have:
- strong brands with a sustainable competitive advantage
- rising market share and/or rising product demand
- consistent earnings growth throughout the cycle
- opportunity for international expansion of its brand
- a strong and deep management team
- a track record of rising dividends
- a solid financial position
- reasonable price stability

Valuation Matters
Companies that meet our criteria for attractive investment candidates will not necessarily have a Buy recommendation depending on a valuation analysis. Our fundamental opinion of a company is only valid at the right price. In valuing consumer companies we use discounted cash flow models to determine the fair value of a stock and compare that to the current price to see what expectations are already factored in. We also use ratio analysis such as price-to-earnings (P/E), PEGY (P/E divided by growth plus dividend yield), price-to-EBITDA (earnings before interest, taxes, depreciation, and amortization), and enterprise value-to-EBITDA. These ratios are then compared to the market, peers, and a company's historical valuation to make a call on the valuation as attractive, appropriate or unattractive. Ultimately, the key decision is to determine if the expectations of the market are too high or too low vs. our assumptions.

Risks
Consumer discretionary stocks are sensitive to the economy and particularly to trends in the labor market because wages determine the discretionary income households may have. In addition, rising interest rates, reductions in consumer spending, higher commodity prices (i.e. gasoline prices), and currency fluctuations could negatively impact both consumer staples and consumer discretionary stocks.

Portfolio Considerations
Even quality companies in the broad sectors of consumer discretionary and consumer staples may perform quite differently depending on specific industry trends. It is important not only to diversify across sectors, but also to diversify within sectors. We suggest owning a combination of Buy-rated stocks from various industry groups, such as Retailing, Consumer Services, Durables & Apparel, and Automobiles & Components for a good
representation within consumer discretionary, and Food, Beverage & Tobacco, Household & Personal Products and Food and Staples Retail within consumer staples. The Retailing and Consumer Services subsectors are the largest components of the consumer discretionary sector, so we recommend a relatively higher exposure to these groups. We recommend an aggregate weighting of 18% for consumer companies, with 9% in consumer staples and 9% in consumer discretionary companies.

Many of the companies that we believe have the best potential for competitive returns are members of the Edward Jones Stock Focus List and the Equity Income Buy List. The following charts illustrate the consumer companies on both lists. The building blocks are arranged by our Price Movement indicator with Above Average at the top, Average in the middle and Below Average at the base. Our advice is to choose stocks where appropriate based on Price Movement and sub-sector diversification needs.

Please see the full opinions of the individual companies mentioned in this report for additional information, including valuation and risks.

Prices and opinion ratings are as of 10/30/19 and are subject to change. Sources: Edward Jones, Reuters. *The S&P 500 Consumer Staples Index consists of 33 consumer staples companies within the S&P 500 Index. The S&P 500 Consumer Discretionary Index consists of 63 consumer discretionary companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly. Past is no guarantee of future results.

Required Research Disclosures

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

Brian P Yarbrough, CFA; John Boylan, CFA
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**Other Disclosures**
All investment decisions need to take into consideration individuals' unique circumstances such as risk tolerance, taxes, asset allocation and diversification.

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