Boring Can Be Beautiful

With all of the recent volatility in financial markets (artificial intelligence, tariffs, etc.), it is important to remember that 'boring can be beautiful' in the investing world.

We would argue that consumer packaged goods (CPG) companies have long been one of the most "boring" groups in one of the least exciting sectors (consumer staples) of the market. In short, CPG companies sell food, beverages, household and personal care products, pet food – many of the things you'd find at the local grocery store, Walmart, Target, or CVS.

Generally speaking, these companies have strong brands, enjoy resilient demand for their products, generate slow but steady growth in earnings and cash flows, and pay healthy dividends. They are rarely mentioned in news headlines or at cocktail parties, especially in the age of artificial intelligence. But over time, CPG companies can play a critical role in portfolios. They are often counter-cyclical investments, providing downside protection, a port in the storm, when markets decline. In exchange, they usually offer more modest upside in rising markets. In other words, heads they win, tails they often still do well.

"This is all very boring ... "

Credit: www.CartoonStock.com

Over much of the past 15 years, many investors viewed CPG companies as attractive alternatives to bonds. With U.S. interest rates at or close to zero, and negative in some parts of the world, the interest that investors earned from bonds declined. Investors found CPG companies' resilient cash flows and healthy dividend payments to be appealing, which became a tailwind to CPG stock prices and valuation multiples.

However, since the COVID-19 pandemic five years ago, CPG companies have been anything but boring. And more recently, anything but beautiful.

In 2020 and 2021, CPG companies enjoyed unprecedented demand. During the pandemic, restaurants and bars closed and we all collectively consumed more food and beverages (including alcohol) at home. A movement towards self-care increased demand for skincare and other personal care products. Pet adoption rates jumped, driving growth in pet food, treats and toys. Adding fuel to the fire, many consumers were flush with cash after multiple rounds of stimulus checks and reduced spending on flights, hotels, and concert tickets. Many CPG stocks soared.

The tables started turning in late 2021 into 2022. Economies reopened, clearing the way for consumers to shift spending to more experiences, including bars and restaurants, which inevitably reduced demand at the margin for CPG products. Perhaps more impactful, inflation spiked to levels unseen in several decades. This forced CPG companies to raise prices to offset their own rising costs. But consumers also came under pressure in these inflationary times. Many pushed back on price increases at the grocery store, instead opting for lower priced private label brands and/or forgoing purchases of certain items altogether.

Reflecting these developments, many CPG companies suffered in the last three years. So have their stock valuations and prices. Adding insult to injury, interest rates increased significantly, driving bond yields to the highest levels in over twelve years. And with pressures mounting on CPG companies, these stocks lost their status as bond alternatives. The combination of weaker business results and lower stock valuations drove significant declines in the price of many CPG stocks.

This one-two punch of temporarily challenging results and depressed valuations can create compelling investment opportunities, which is why we've doubled down on our CPG research efforts. For example, we recently made our annual trip to the Consumer Analyst Group of New York (CAGNY) industry conference in Orlando, FL. At the event, we had the opportunity to engage with CEOs, CFOs, and other leaders of over 30 CPG companies. Our goal was to enhance our understanding of each company's challenges and opportunities, how management teams are reacting and repositioning their businesses, and ultimately, whether a company's stock represents an attractive investment over the next 3-5 years.

To supplement our work at CAGNY and similar industry events, we often speak with a company's customers, suppliers, competitors, industry consultants, and other investors to understand different viewpoints. These wide-ranging conversations are critical in shaping our investment perspectives. One recent conversation took us as far as Vevey, Switzerland to meet with Nestle's management team and tour one of their research and development facilities.

Of course, as part of our research process we also review SEC filings (annual and quarterly reports, proxy statements, prospectuses), build financial models to project future results and run scenarios, and read as much as possible – financial newspapers, industry trade magazines, investment newsletters or anything else we can get our hands on.

On top of this fundamental analysis, we also consider investor sentiment and expectations. For example, what level of future business performance is implied in the current stock price? How do these expectations differ from (our perception of) reality? The pendulum of investor expectations can swing too far in both directions, and we often find that companies are not as good or as bad as their stock prices may suggest.

With low investor expectations, even subpar business performance can be rewarded with a higher stock price. "Better than feared" results are often enough to catalyze new investor enthusiasm. Conversely, with overly optimistic expectations, excellent business performance may not be enough to drive a stock higher. Case in point, several companies gave downbeat near term outlooks at CAGNY, but their stocks actually went up throughout the 4-day conference as investors considered that some of the bad news was already reflected in their current stock prices.

All told, our investment research process is very much a combination of art, science and experience. We often liken it to a mosaic. We collect many disparate observations and data points that, individually, may seem unrelated. It's only after we compile, analyze, and step back to consider the bigger picture that our investment conclusion becomes clear. Our goal is to evaluate a large number of opportunities, turn over as many stones as possible, and distill the many thousands of publicly traded stocks down to a diversified portfolio.

Thinking about our CPG mosaic, there is a lot to like these days. Companies are sharpening their efforts around consumer insights, product innovation, and marketing; evolving price-pack architectures (meaning smaller sized products at lower price points, which often generate higher profit margins); revamping brand portfolios through acquisitions and divestitures; and wringing out costs through operational efficiencies. Perhaps most important, household incomes are starting to catch up to rising costs of living. Should this trend continue, it could put the U.S. consumer on firmer footing which may be a nice tailwind for the CPG industry.

Moreover, investor expectations of CPG companies have moderated. The stocks are certainly "out of favor", to put it kindly. Many CPG stocks are down over the last three years and have fared even worse relative to a very strong stock market.

Of course, all companies come with risk. Recent concerns for CPG companies include: 1) GLP-1 weight loss drugs like Ozempic and Wegovy may impact consumption of CPG products, 2) a recent focus on product ingredients may require companies to reformulate some of their products, 3) potential tariff risks, 4) ongoing inflationary pressures. That said, we think many CPG companies will navigate these risks successfully.

This "Views From The Road" gives you a window into how we research and analyze not only the CPG industry but all industries. As you'd expect, we continue to refine our views across the CPG landscape, evaluate risks and rewards, and adjust our own expectations in the face of evolving business results and stock prices. In a world with high-voltage headlines coming fast and furiously, perhaps CPG companies will be boring and beautiful again soon.

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