Morgan Stanley
INVESTMENT MANAGEMENT

Global Equity Observer

The case for consumer staples

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At the time of writing, consumer staples appear out of favour and somewhat overlooked. Since the end of the pandemic in 2022, while the sector's earnings have grown in the mid-single digits per year,[1] close to the broader market's growth, its stock prices have struggled in relative terms.

Notably, compared to the MSCI World Index, consumer staples are now at a near 25-year low in terms of relative valuation and are at their lowest weight in the index this century.[2] In contrast, investor interest has shifted toward more fashionable sectors and themes such as artificial intelligence, global mega-tech, and health care innovations aimed at combatting obesity. Despite this trend, we believe the consumer staples sector still encompasses some of the world's most resilient and dependable companies.

High quality characteristics

High quality staples companies can play a crucial role in a portfolio by delivering consistent, reliable growth, driven by recurring revenue from the everyday products they sell. Their typical operating resilience during economic downturns serves as a key advantage, offering relative downside resilience and acting as a stabilising force within the portfolio.

Challenging times

While recent stock price returns for some consumer staples have not met expectations, over the past four years the sector has demonstrated impressive resilience, navigating the pandemic, soaring commodity costs, and numerous emerging market currency devaluations. Despite these challenges, the USD sales and earnings of our staples holdings have managed to grow at mid-single-digit levels,[3] affirming their resilience and compounding potential.

[1] Source: FactSet, September 2024
[2] Source: FactSet, September 2024. MSCI World Index
[3] Source: FactSet, September 2024

AUTHOR

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Managing Director

"Despite an exceptionally turbulent four years, the consumer staples sector has demonstrated resilience, justifying a place in our portfolios."

The right company in the right categories

As investors, we don't allocate capital by sector but focus on reasonably valued individual companies with strong fundamentals and long-term growth potential. Not all consumer staples fit this profile. In our view, being in the right category where brands matter and the consumer responds to innovation is key. Importantly, companies need to sustain high levels of investment in their brands in the form of marketing, research and development (R&D), supply chain capabilities and talent.

A good example of this is a U.K.-based global leader in the consumer health sector that we have recently established a position in. The company is sharply focused, with nine powerhouse brands across just five categories, all addressing critical consumer needs—sensitive teeth being one example. Their dominance in the therapeutic oral care category is supported by direct relationships with one-third of the 10 million health care professionals,[4] who serve as trusted influencers. These partnerships play a vital role in driving consumer acquisition and retention, resulting in strong brand loyalty, industry leading margins, and non-cyclical growth.

Being innovative and remaining relevant is crucial

Our holdings across beauty, home care, consumer health and beverages innovate to solve consumer needs. This expands consumer usage and drives category growth. Innovations range from energy-efficient laundry detergents to improved solutions for sensitive teeth, "nolo" (no or low alcohol) and zero-sugar drinks, faster-acting antacids, or improved sun-filtering technology to help protect skin. These innovations are supported by well-invested supply chains and high levels of marketing support, meaning the brand's "share of voice" is above their market share. In so doing, the companies outpace their market and grow share. We avoid food retailers, which are typically low return, capital intensive, price takers—a well-known player in the space is successful precisely because it operates a high volume, low margin business—and mass food producers, whose competitive moats may face threats from local or specialist producers.

Marketing matters

When we see a period of underinvestment, we seek to act. We exited one of our global beer holdings, which had been reducing marketing spend. This may boost short-term earnings, but it harms long-term brand strength. Recovering from this is often challenging. Conversely, we've increased our position in a world leader in beauty, which allocates over 30% of its sales to marketing. This investment provides the company with a share of voice 1.5 times greater than its market share, enabling it to have consistently outperform the market.[5]

Pivoting to where the growth is

Agility is a key attribute we seek in our selection of consumer staples. In a world of economic and geopolitical uncertainty, the ability of management teams leading global operations to swiftly allocate resources—capital, talent and marketing—to the most promising markets is essential.

China's current economic challenges, including rising local government debt, a struggling housing market, deflation and cautious consumers, have led to a marked slowdown in a once fast-growing market. Recent and sizeable stimulus measures may help, but also highlight policymakers' concern for the growth outlook. Fortunately, there is another market of approximately 1.4 billion consumers set to pick up the growth mantle. After years of being the next great hope, we believe India is showing signs its time has come, with its investment in infrastructure, from roads to electricity to digitalisation, contributing to strong gross domestic product and consumption growth. A beverage company we own is investing in 40 new production lines in 2024 to capture this potential growth opportunity.[6]

The spirits industry has faced recent challenges

Market normalisation in the U.S. following the COVID-induced cocktail boom, coupled with a sluggish consumer recovery in China, has impacted the spirits industry's sales and earnings growth in 2024. The consumer slowdown was further exacerbated by distributor destocking.

We see these issues as cyclical rather than structural. And with the industry's valuation at historically low levels relative to the MSCI World Index, we believe our long-term mindset is likely to be rewarded if the spirits companies we own see their earnings and multiples recover from trough levels.

Why we believe our consumer staples holdings can continue to compound

Looking ahead, after an exceptionally turbulent four years in which the consumer staples sector faced its most challenging environment in a generation—yet demonstrated resilience, with mid-single-digit sales and earnings per share

[4] Source: International Equity Team research

[5] Source: Company reports; International Equity Team research

[6] Source: Company reports; International Equity Team research

(EPS) growth (albeit below market EPS growth)[7]—we remain confident that staples justify a place in the portfolio for a number of reasons.

Notably, our staples holdings are now at record levels of marketing and R&D spend,[8] setting them up to potentially outgrow their market. Further, efficiency gains are coming from investments in automation, upgraded enterprise resource planning systems, digitalisation and artificial intelligence. As a result, we expect earnings growth to return to high-single-digit levels driven by a more balanced combination of volume, price mix, margin improvement and strong free cash flow. Additionally, valuations are attractive, with our holdings trading at their 20-year average, compared with what we view as a generally extended market.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

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[7] Source: FactSet, September 2024

[8] Source: Company reports; International Equity Team research

DEFINITIONS

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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