I

GETTING STARTED IN CONSUMER DISCRETIONARY

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CONSUMER DISCRETIONARY BASICS

Whether you're a blue-blooded socialite or a blue-collared mechanic, the Consumer Discretionary sector plays a material role in your everyday life. How? Consumer Discretionary may conjure images of high-end jewelry, luxury cruises, mega-big-ticket electronic goodies, and other high-priced glamour items—and those items do fall within the sector, but it is much broader than that. For example, just the process of buying and enjoying this book likely involved a number of goods and services from Consumer Discretionary firms.

Odds are, you purchased this book from a bookstore (a Specialty Retail firm). Perhaps you drove your car (produced by the Automobile industry) to that bookstore and stopped for a coffee (Hotels, Restaurants, & Leisure firm) on the way to or from. Maybe you're reading this from the comfort of a recliner or on the screen of a new handheld device (both built by a Household Durables firm). The book itself was published by John Wiley & Sons (a Media firm). These are just a few industries included in the Consumer Discretionary sector.

Although these categories represent the sector from a high level, it is important to reiterate this segment's breadth. Auto manufacturers, homebuilders, sports equipment manufacturers, hotel developers and operators, advertising agencies, newspaper publishers, cruise lines, car dealerships, retail websites, department stores, and beauty salons are all examples of Consumer Discretionary firms. In other words, it's more diverse than you might think.

This chapter introduces you to the Consumer Discretionary sector and its five industry groups. You should finish the chapter with a high-level understanding of the sector, how to identify its components, and what exactly makes a firm Consumer Discretionary.

CONSUMER DISCRETIONARY 101

Globally, the Consumer Discretionary sector makes up about 8.8 percent of world stocks—just a bit smaller than the Staples sector (see Table 1.1). This amount isn't static. All sectors change in relative size as they come in and out of favor and the stocks get bid up or down.

It's not a massive sector, but the variety of firms included is immense. One might ask, "What do newspapers and cruise lines have in common? Why are they in the same sector?" Or perhaps, "What about cigarettes or beer? Those are discretionary goods, right?" Or even, "What's the

Table 1.1 MSCI ACWI Sector Weights

Sector	Weight (%)
Financials	20.2
Energy	12.0
Information Technology	11.8
Industrials	9.9
Consumer Staples	9.8
Health Care	9.7
Consumer Discretionary	**8.8**
Materials	7.6
Telecommunication Services	5.3
Utilities	4.9

Source: Thomson Reuters, as of 6/30/2009.

Elastic versus Inelastic

Frequently in this book, we'll refer to a product being *elastic* or *inelastic*, or that demand is *elastic* or *inelastic*. So what does that mean? It means a lot like it sounds. Elastic demand stretches and snaps back, whereas inelastic demand stays constant. This is the core of the difference between Discretionary and Staples firms. When times are flush, the economy is growing, incomes are rising, and people are more likely to buy bigger ticket items, take pricier vacations, eat out at restaurants, etc. That benefits Consumer Discretionary firms' bottom lines and usually translates into rising stock prices too. But when the economy slows or goes into recession, demand for those things snaps back, usually hurting Discretionary firms' earnings and stock prices.

On the flip side, demand for Consumer Staples goods is usually inelastic. Whether times are good or bad, people still need to brush their teeth and buy basic foodstuffs. If the economy is raging, people don't buy *more* toothpaste. And if the economy falls, they typically also don't spend less (or at least, not much less) on these items. Demand is stable—*inelastic*. Sectors that are more inelastic are sometimes also called *defensive* because they usually perform better on a relative basis during bear markets or when the broad market is overall sluggish.

difference between Consumer Staples and Consumer Discretionary?" To answer these questions, let's begin with some definitions.

Misleading Names

The first word, "Consumer," is simple—if you have ever purchased something, you are a consumer. (Note this definition does not typically include purchases made by businesses.) Put another way, if a good is made for "final" use by someone, it's a consumer good. Goods made for businesses are often called "capital" or "enterprise" goods because they're used in the process of creating something else.

The second piece, "Discretionary," if taken as the dictionary definition, refers to something done based on one's prerogative (i.e., needs versus wants). Basic food, shelter, and clothing are most frequently associated with necessities, while most everything else can be classified as a want, or discretionary. Using this definition, restaurants (food), homebuilders (shelter), and apparel manufacturers (clothing) might seem better categorized as Staples, as these are all necessities, not discretionary items. Similarly, cigarettes and alcohol *would* be considered Discretionary, since they are clearly not necessities.

Except, seemingly illogically (at least at first) restaurants, homebuilders, and apparel manufacturers are included in the Consumer Discretionary sector, while tobacco and spirits producers are Staples (see *Fisher Investments on Consumer Staples* for more information). So, to understand how to identify a Consumer Discretionary firm, it's better to define the group using common characteristics. Typically, firms in the Consumer Discretionary sector are:

- Economically sensitive
- Highly correlated to broad stock market performance
- Sensitive to consumer sentiment

Correlations and R-Squared

Few of us voluntarily hearken back to Statistics 101, but this book relies heavily on the use of correlations and correlation coefficients (R-Squared) to gauge the strength of certain relationships. We'll skip the heavy math and keep it simple with some qualitative explanations of what these measures describe. A correlation tracks directional relationships between two or more variables and falls between 1.0 and –1.0. A correlation very close to 1.0 means two things are strongly *positively* correlated—they move in the same direction at the same time and in about the same amount. A correlation close to –1.0 means two things are strongly *negatively* correlated—one's up when the other's down. A correlation close to 0 means there's no relation—their movements are entirely independent and there's no clear pattern.

But be careful! Correlations do not imply *causation*; they simply tell us about their movements. Things can be correlated all the time—doesn't mean the one causes the other's movements. When you discover a strong correlation—positive or negative—ask whether the relationship makes sense and try to find a fundamental reason for the link. Many correlations are merely coincidental, not causal.

The *correlation coefficient*, or R-Squared, is another useful measurement, telling you how much of the change in one variable can be explained by changes in the other. It's simply the correlation, squared. The number ranges from 0 to 1.0—the closer to 1.0 the stronger the relationship. As a rule of thumb, if the correlation coefficient is above 0.5 (half of the movement in the dependent variable can be explained by movements in the independent variable), there is a fairly healthy relationship.

Economically Sensitive

A healthy, growing economy is vital to the Consumer Discretionary sector. Personal consumption expenditures (PCE; also known as consumer spending) are a key demand driver for Consumer Discretionary stocks and make up approximately 70 percent of gross domestic product (GDP)[1]—which will be covered more in Chapter 3.

Keep in mind, not all that spending goes toward goods and services produced by Consumer Discretionary firms. A major chunk of total spending—about 66 percent as of 2009—goes toward services, which includes things like health care, financial services, etc. Another big chunk goes toward non-discretionary items typically found in the Consumer Staples sector. Only about 12 percent of spending is attributed to *durable* goods, which most directly impact Consumer Discretionary firms (though there's some overlap in spending, covered more in depth in Chapter 3). So while a major portion of global GDP is attributed to consumer spending, the goal of a Consumer Discretionary analyst is to understand what impacts the portion most important to Consumer Discretionary stocks.

Still, most Consumer Discretionary firms benefit from an overall strong spending environment. For example, when personal income and spending are strong or growing, consumers generally eat at restaurants more frequently—which fall in the Discretionary sector. However, they won't necessarily purchase an extra loaf of bread at the supermarket (a Staples firm). This is why restaurants are included in the Discretionary sector and grocery stores are not.

Beeronomics

When the economy is weakening and unemployment is rising, what happens to alcohol sales? A common myth during periods of economic weakness suggests consumers—supposedly depressed by job losses and a dour economic outlook—turn to booze as a way to self-medicate. This seems plausible—not many would argue with enjoying a few potent potables after hitting a particularly rough patch. But if this were true, we'd see a meaningful, negative correlation between alcohol sales and economic growth. In other words, when the economy falls, alcohol sales would rise. Unfortunately for believers of this myth, alcohol sales and economic growth show no material connection (see Figure 1.1).

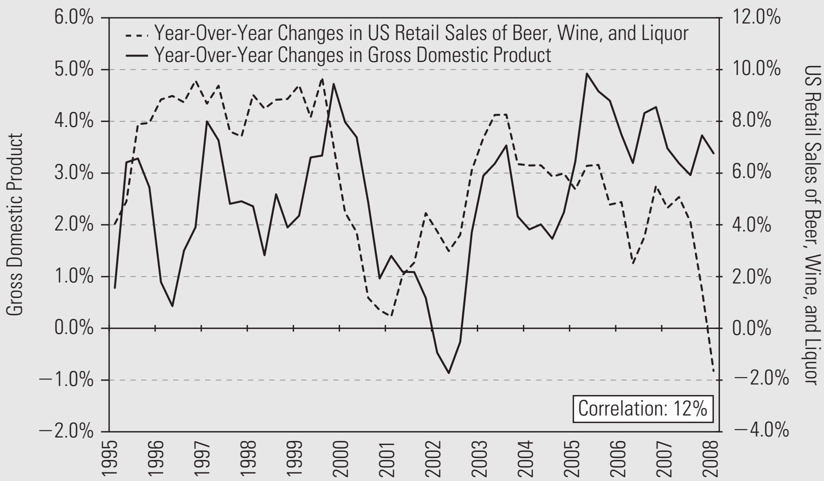

Figure 1.1 GDP and US Retail Sales of Beer, Wine, and Liquor Stores

Source: Thomson Reuters.

A Nielsen survey in May 2008 showed 80 percent of respondents indicated they had no intentions of changing their drinking habits in response to the weakening economy. Put simply, booze is a relatively cheap indulgence, and the economy, whether growing or shrinking, has minimal impact on consumption. Remember, in the Consumer Discretionary sector, demand is usually leveraged to economic growth. Since there's no meaningful relationship, alcohol isn't a good fit for the Discretionary sector.

Source: Christopher Farrell, "Economic Trends," *BusinessWeek* (November 12, 2001), accessed on December 11, 2009; "Declining Economy Has Little Impact on Consumers' Alcoholic Beverage Purchases in Stores," Nielsen (June 3, 2008), accessed on December 11, 2009; Adam Geller, "During Downturn, People Find Money for Booze," Associated Press (September 7, 2008), accessed on December 11, 2009.

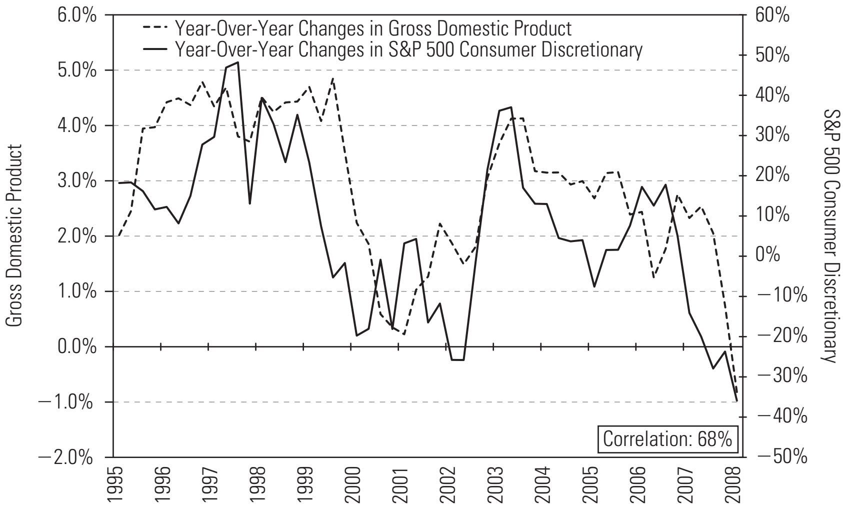

Figure 1.2 GDP and S&P 500 Consumer Discretionary Growth

Source: Thomson Reuters.

When consumers are spending, the largest portion of the economy benefits—and vice versa. This relationship is the primary factor linking the sector so closely to economic growth. Figure 1.2 illustrates the relationship between economic growth and Consumer Discretionary stock price performance. You can clearly see Consumer Discretionary stock prices frequently rising and falling alongside the economy.

Since consumer spending represents such a large portion of economic output, an understanding of its components and drivers is imperative to any analysis of the Consumer Discretionary sector. We'll detail these factors in Chapter 3.

High Correlations

In addition to being "The Great Humiliator" (see Ken Fisher's *The Only Three Questions That Count*), the stock market can also be called "The Great Discounter," as in discounter of future earnings. In other words, when investors expect earnings will be strong, broad stock market performance is typically positive. Investors are generally bullish

Table 1.2 A Strong Relationship

Industry	Correlation	Weight (%)
Media	0.90	50.5
Automobiles	0.80	5.7
Multiline Retail	0.76	16.2
Distributors	0.77	1.3
Specialty Retail	0.77	38.0
Hotels, Restaurants & Leisure	0.70	30.4
Average	0.62	N/A
Internet & Catalogue Retail	0.59	7.3
Auto Components	0.59	3.8
Textiles, Apparel & Luxury Goods	0.48	8.9
Leisure Equipment & Products	0.44	2.3
Household Durables	0.35	7.0

Source: Thomson Reuters, Standard and Poor's, as of 6/30/2009.

on future earnings when trends in employment, wages, and spending are favorable or improving—the same conditions that favor Consumer Discretionary earnings. As a result, the Consumer Discretionary sector and its industries are highly correlated to broad stock market performance. Table 1.2 shows Consumer Discretionary 10-year industry correlations to the S&P 500 as of June 30, 2009. Comparing Consumer Discretionary industry correlations to the average industry correlation of the S&P 500 shows how closely related Consumer Discretionary performance is to the index, especially for the biggest constituents.

Getting in the Mood

Another common feature of Consumer Discretionary stocks' performance is how consumer sentiment can impact demand for a company's goods or services. Let's face it, happy consumers are good for the economy. A consumer with a positive economic outlook is more likely to buy a new car than one who thinks his job is in jeopardy.

However, that same consumer is unlikely to buy an extra loaf of bread just because he got a raise and feels secure in his job. While not a fundamental driver, understanding how sentiment impacts demand for certain goods can help determine if a company fits in the Consumer Discretionary sector.

Sentiment is measured by a variety of organizations. The Conference Board, the University of Michigan, and the *Washington Post*-ABC News each measure and publish various gauges of consumer confidence.

The three major surveys use different methods and seek different information. For instance, the Conference Board surveys 5,000 households on a weekly basis to track how consumers feel about the job market and the economy. It pays little attention to expectations for household spending. The University of Michigan surveys 500 adults regarding their outlook on financial and spending matters, while the *Washington Post*-ABC News poll surveys 250 people on a weekly basis about current economic conditions. These inconsistencies result in a variety of indexes with often-disparate findings and rarely serve as a gauge of future stock market performance. However, it is important to understand the underlying message the sentiment indexes are conveying.

Ironically, while the condition these surveys measure is powerful, the results of the surveys have little correlation with stock market performance. For example, Figure 1.3 compares the Conference Board's survey of future stock market expectations with forward performance. The correlation is an insignificant 0.25. This isn't to say expectations don't matter—on the contrary! Figure 1.4 takes the same sentiment data and compares them with *current* stock market performance. The correlation is a much stronger 0.79. The explanation is simple: If consumers expect stocks to be higher (or lower) in 12 months, they will act accordingly *today*, not in 12 months.

Although positive sentiment is typically a good sign for consumer spending, using sentiment as a forecasting tool is usually fruitless. The key is understanding trends. (The role of sentiment is discussed in more depth in Chapter 3.)

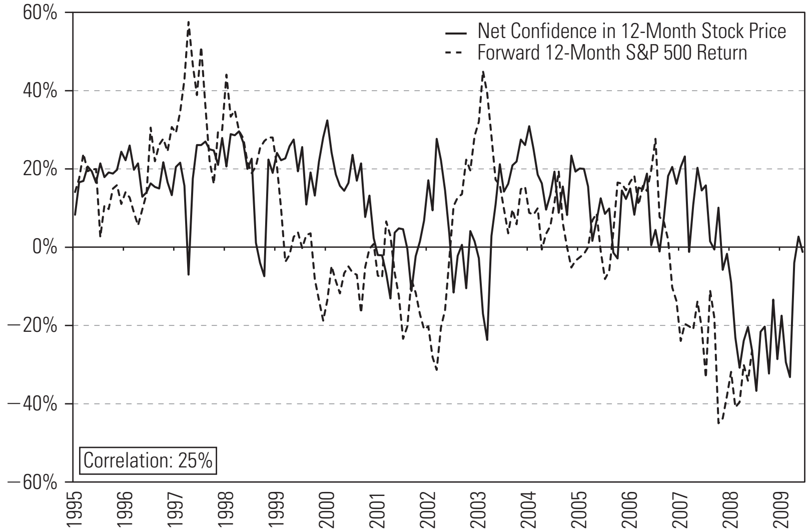

Figure 1.3 Conference Board Future Stock Market Expectations vs. Future S&P 500 Returns

Source: Thomson Reuters.

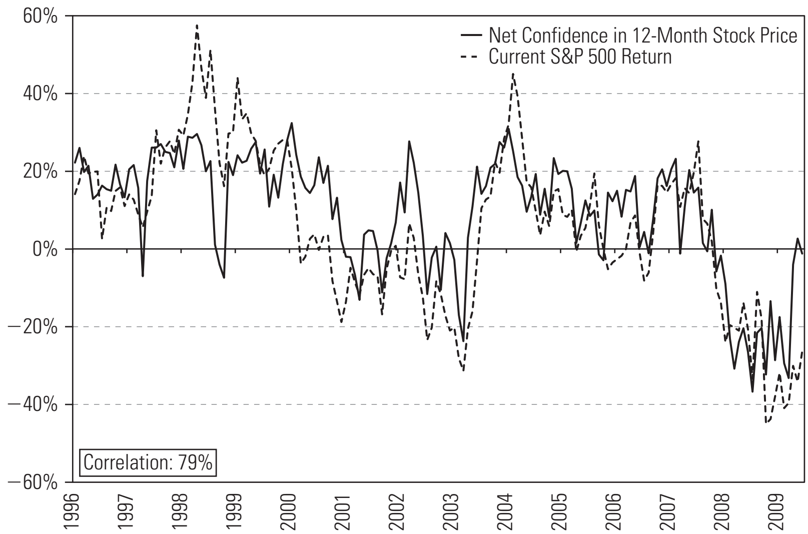

Figure 1.4 Conference Board Future Stock Market Expectations vs. Current S&P 500 Returns

Source: Thomson Reuters.

Black Friday

Black Friday is the day after Thanksgiving and the official start to the holiday shopping season. Often cited as the busiest shopping day of the year, retailers typically extend hours and may dramatically reduce prices to drive shoppers into their stores. Before spreadsheets rendered hand-written income statements obsolete, accountants used to denote losses in red and profits in black. As the story goes, Black Friday got its name because it was the first day of the year retailers overcame their fixed costs to go "into the black."

Seems straightforward, but there's another explanation for the name, tracing back to 1966 and cranky Philadelphia policemen. Griping about massive traffic jams and overcrowded sidewalks, local police began referring to the day as "Black Friday" in relation to the headaches it caused, not the profits it created.

Also, according to the International Council of Shopping Centers, an industry trade group, Black Friday is typically not the busiest day in terms of sales. While it is consistently in the top 10, the weekend before Christmas tends to see stronger sales. As online retailing has grown, the Monday after Thanksgiving—"Cyber Monday"—has grown in significance too. Finally, although the holiday season typically generates the largest profits of the year, most retailers are profitable all year long.

Source: The American Dialect Society, International Council of Shopping Centers.

GETTING TO KNOW THE CONSUMER DISCRETIONARY SECTOR

Now that you know some of the high-level commonalities of the sector, you can begin to understand each of the sector's industries. Remember, this is a broad overview—Chapter 4 addresses the sector's constituents in much more depth.

Automobiles & Components

The Automobile industry has long been a symbol of ingenuity and prosperity. As a means of transportation and a major piece of manufacturing infrastructure in global economies, the automobile can be both a means of growth and a symbol of wealth. Automobile manufacturers and component suppliers are included in this industry.

Automobile manufacturers, also known as original equipment manufacturers (OEMs), produce automobiles for both private and commercial use. Passenger cars and light trucks are the primary types of vehicles these firms produce. Component manufacturers supply automobile manufacturers with everything from tires to stereos to airbags.

In periods of strong economic growth, demand for automobiles is stronger as disposable income supports purchases of new automobiles (and the underlying components). Cyclicality in demand is intuitive to grasp; however, earnings volatility can be immense as fixed manufacturing costs are high. The larger and more expensive an item, the less likely a consumer is to commit to a purchase if his or her outlook is sufficiently bleak. Therefore, sentiment plays a large role in automobile demand.

Retailing

The retail industry is possibly the most recognizable industry in the Consumer Discretionary sector. From Home Depot to Neiman Marcus, Target to Williams Sonoma, the retail industry provides consumers with many of the goods used in daily life. There are two types of retailers: Multiline and Specialty.

Multiline retailers come in two forms: department stores and general merchandisers. Department stores sell a wide variety of goods, but focus primarily on apparel and cosmetics. General merchandisers provide a wider selection of goods and may include certain nondiscretionary items like groceries. Nordstrom and Macy's are examples of department stores, while Target and Kmart are general merchandisers. Wal-Mart is excluded from this group because it sells a large proportion of groceries that are not economically sensitive.

Specialty retailers emphasize one category of goods. Best Buy and Home Depot are good examples. The former sells a wide variety of consumer electronics, while the latter specializes in home improvement supplies. Since these companies carry such deep selections of one category, they are referred to as "category killers" because competing general merchandisers often lose sales of entire merchandise categories to these companies.

The link to consumer spending and sentiment is evident in the Retailing industry group. When spending is strong and sentiment is positive, retailers are often able to sell more items and at higher prices. This relationship supports one of the highest correlations to overall stock market performance of all its Consumer Discretionary sector peers.

Media

The Media industry includes Advertising, Publishing & Broadcasting, Cable & Satellite, and Movies & Entertainment firms. Firms in this category create and distribute content—feature films, television shows, advertisements, books, newspapers, and music, among others.

Revenue is primarily generated via advertising, subscription fees, book or magazine sales, and box office sales. Each sub-industry focuses on a different type of revenue. For instance, a broadcaster generates the majority of its revenue by selling advertising space, while a cable company relies primarily on monthly subscriber fees.

These firms fit the criteria we introduced earlier in the chapter. Specifically, revenue is driven by demand for advertising and by strong consumer spending. A growing economy supports both conditions. Additionally, profits are highly cyclical. The fixed costs associated with running a newspaper or producing a movie are immense—in the event of an economic downturn, profitability is quickly impaired. Finally, when sentiment is weak and consumers are not spending, advertising is less profitable. This reduces demand for advertising and diminishes earnings.

Consumer Durables

As its name implies, this industry produces consumer goods meant for durable use ("durable" goods are designed to last more than three years). Appliance manufacturers, homebuilders, and consumer electronics firms are included here.

Appliance manufacturers produce a variety of goods to meet new and replacement demand. These firms manufacture major appliances (refrigerators, washing machines), smaller appliances (microwaves, toasters), and home furnishings (dining room sets, bedroom furniture). Intuitively, homebuilders build homes after investing in land and local infrastructure. Consumer electronics firms manufacture electronic goods—televisions, home theater and audio, and a variety of other consumer-focused items.

Not long after purchasing a new home, many consumers purchase new appliances and home theater products. Because the purchase of a new home is driven by growth in disposable income, economic expansion, and favorable interest rates, demand for durable consumer goods is leveraged to economic growth. Considerable fixed costs—both in the form of manufacturing facilities and, in certain cases, research and development—provide significant operating leverage and magnify earnings cyclicality. Since durable goods are often big-ticket items requiring financing, sentiment and interest rates play a large role in driving demand.

Consumer Services

Hotels, Restaurants & Leisure are the main categories in this industry group. The lodging industry provides accommodations for leisure and business travelers. Hotels come in a variety of formats, including ownership, management, or franchised. Deciding whether to own or franchise in the restaurant industry is also important. The leisure industry includes theme parks, cruise lines, and travel agencies. These companies provide accommodation and planning services to a variety of consumers.

Business activity and consumer spending are the primary drivers of revenue in this segment. These firms enjoy strong earnings growth in expanding economies and face significant declines in weakening economies. Like other industries within the sector, spending on travel is leveraged to sentiment as expectations of an impending layoff will generally prevent households from booking a major vacation.

Chapter Recap

By now you should have a basic understanding of what kinds of companies comprise the Consumer Discretionary sector. Understanding the characteristics these companies share is vital to your understanding of the broader sector and will be the foundation this book builds on. You should also be familiar with what types of companies are included in the sector and how these firms fulfill the identifying criteria we've introduced.

- The Consumer Discretionary sector is a part of your everyday life, although identifying what is included and what isn't can be counterintuitive.
- The sector can be volatile owing to its leverage to economic growth and consumer spending.
- Demand for Consumer Discretionary goods and services can be dependent on consumer sentiment.
- There are five basic categories of Consumer Discretionary stocks: Media, Retail, Automobiles, Consumer Durables, and Consumer Services.