Ryan Watson, MBA, CFA

## Keeping up with the consumer

When analyzing consumer stocks, I cannot help but think of the wisdom shared by legendary investor Peter Lynch in his 1993 book, *Beating the Street*. In it, he describes how when looking for retailing stocks, he travels to the local shopping mall with his family, gives some pocket money to his kids, and observes where they spend it. "If you like the store, chances are that you'll love the stock," opines Lynch. The publication year of his work is important because nowhere are terms like 'mobile app,' 'online,' or 'Apple Pay' even mentioned. The digital revolution and ensuing development of e-commerce solutions has clearly changed the retail landscape.

A 2016 survey by Canada Post indicates that 52% of individuals who shopped online did so because it could be done anytime and anywhere, i.e. it was convenient. Companies like Amazon have created massive global online marketplaces, making it easier for merchants to sell direct to customers, and for customers to shop from wherever the Internet is accessible. E-commerce is expected to continue to outpace traditional retail. In Canada, online sales are anticipated to grow at a rate of approximately 13% per year through 2020, and reach more than 10% of total retail sales.

Consider the role online plays in your own shopping habits today versus ten years ago. It may then come as no surprise to learn that the majority of North American department stores posted weaker sales in 2016 compared to 2015. The competitive environment has become so challenging that Sears Holdings Corp. stated in its Annual Report that its "historical operating results indicate substantial doubt exists related to the Company's ability to continue as a going concern." Suffice it to say, the stocks of most brick-and-mortar retailers have also not performed well over the past year.

One of the obstacles in the analysis of consumer companies, arising from our daily encounters with them, is overcoming our biases. The propensity to emphasize recent experiences in decisions about the future is referred to as recency bias. It can make investors overly negative (or positive) towards a business, and this sentiment often gets reflected in the business' share price. Whether it is deflation at grocery stores, employees feeling pressured at banks, or discontent franchisees at restaurant chains, the QV Canadian Equity Strategy has felt the impact. There will always be news around one or more of our companies. The time to worry, though, is when the issues could impair the franchise and fail to be addressed by management.

As we review the consumer holdings in the portfolio, we are pleased with the strides our businesses are taking to keep up with technology and tastes. For instance, Canadian Tire, a near century old retailer, has expanded its capabilities over time to become a national leader of household products offered through various platforms like in-store, online, and mobile. The lack of a consistent home delivery offering from Canadian Tire online is an ongoing frustration. However, the company is aware of the risks created by this disadvantage and is taking a measured approach to ensure it can be done profitably. So far, the company's efforts have resulted in positive same-store sales growth across its key banners in all but one year coming out of 2009.

In another example, Cineplex, widely known as the operator of Canada's largest movie theatre network, has leveraged its skills in entertainment to diversify its revenues. The company has broadened the use of its theatres in becoming North America's largest electronic sports and gaming stage. Furthermore, with The Rec Room entertainment lounges and its "digital ecosystem" project that engages customers in shopping centres, Cineplex is providing the services and experiences that millennials (those born since the early 1980s) prioritize.

Consumer businesses have their work cut out for them to stay relevant. With traditional retailers, in particular, seeing their valuation multiples move lower, the market is doubtful of their future. As we have highlighted above, however, good companies have the ability to adapt. If we can draw again from Lynch's wisdom: "Great companies in cold, non-growth industries are consistent winners." And an attractive valuation is usually a good starting point to finding them.