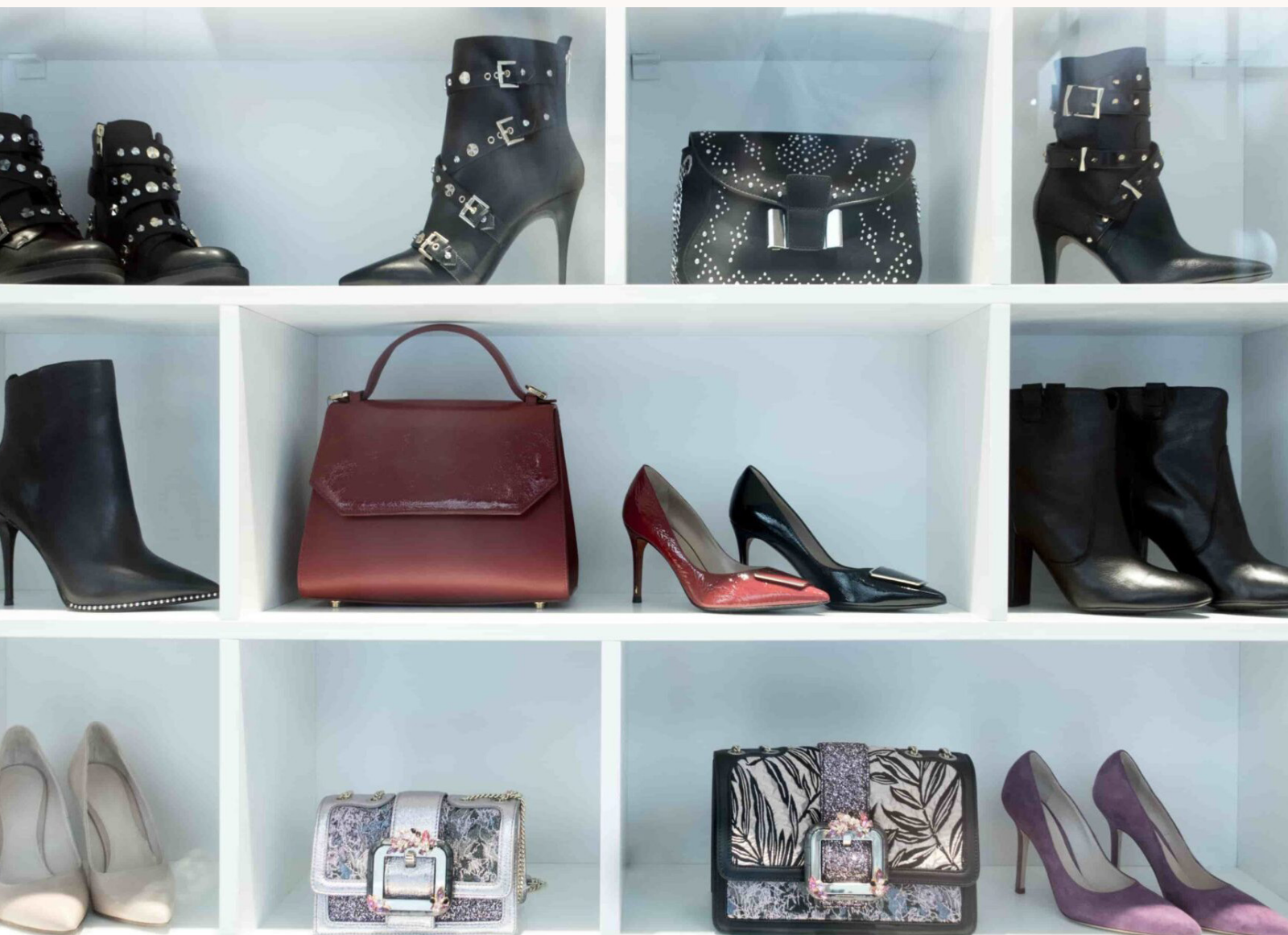




Investing in Non-Essential Consumer Goods

The consumer discretionary sector



The consumer discretionary sector offers a diverse range of products and services, from luxury fashion brands and luxury cars to high-end electronics and entertainment. Industries such as retail, hospitality, travel and leisure fall into this sector, presenting growth potential within an investment portfolio. Companies in this sector produce goods and services that, while desirable, are generally non-essential if affordability becomes a constraint for the consumer.

Why invest in consumer discretionary?

During periods of economic growth, consumer spending on luxury and non-essential goods tends to increase, which can lead to higher sales and profitability for companies in the consumer discretionary sector.

The consumer discretionary sector is known for its cyclical nature, often reflecting the ups and downs of the economy. It's closely connected to consumer confidence—when economic conditions improve, this sector is likely to reap the benefits of deferred demand and heightened consumer engagement.

Consumer discretionary—quality matters

The consumer discretionary sector consists of businesses that sell goods and services considered non-essential by consumers. In economic upswings, spending on discretionary items such as designer clothing, electronics, and travel typically increases as consumers have more disposable income and higher confidence in their financial situation.

Not all companies and industries in this sector meet the requirements to be included in the Magellan's investment universe. Extensive research is undertaken to identify the unique attributes of a company such as their economic moat and moat trend, reinvestment potential and Environmental, Social and Governance risk and opportunities that we consider enable it to generate sustainable attractive returns over the longer term. Some of these industries in Magellan's investment universe include:

Restaurants

Restaurants within this sector range from quick service to upscale restaurants, each with its own set of opportunities and challenges. The sector benefits from the growing demand for convenience, the rise of food delivery services, and an increasing interest



in diverse cuisines. However, investors must navigate obstacles like fluctuating food prices, labour shortages, food safety, and the need for continuous innovation to drive store traffic. Understanding the strategic vision and operating model of a company in this industry is key to finding quality companies. Important factors like marketing and digital strategies to attract and adapt to changing consumer experience, menu innovation in customer preference, and compliance with regulatory standards and changes are essential when considering investing in this industry.

An example of a quick service restaurant in this sector is Chipotle. This popular US-based Mexican Grill restaurant chain, founded in 1993, has seen significant growth over time. With over 2,500 locations worldwide, Chipotle is now a major scaled player in this sector. Chipotle's strength

has been driven by its ability to adapt to changing consumer preferences, especially in the trend to health-conscious consumers. Chipotle has adapted, offering smaller portion sizes, fresh ingredients and healthier options. This strength in brand, product and customer needs has been critical in the growth and scaling of Chipotle.

“Leading companies in this sector are those that can adapt to consumer preferences.”

— Magellan Head of Franchises

Discretionary goods, including luxury goods

Discretionary durable goods and apparel can range from everyday brands like Nike and Adidas to luxury brands like Rolex. Critical to all companies in this segment is brand, scale and reinvestment in brand. The highest-quality segment is luxury goods.

The luxury goods market is dominated by numerous prestigious global brands renowned for their enduring legacy and commitment to excellence. Louis Vuitton, Hermès, Chanel, Rolex, Ferrari and Gucci are examples of well-known established brands in this industry. A history of luxury is a competitive advantage, conferring trust, loyalty and desirability among consumers, and often comes with the important pricing power.

These brands that have a perceived value of quality and exclusivity, often have premium price points and attractive profit margins. This industry can benefit from wealthier consumers who typically maintain spending on luxury goods even in tougher economic conditions.

Louis Vuitton Moët Hennessy is a leader in the luxury goods industry, owning over 75 prestigious brands across fashion and leather goods, perfume and cosmetics, watches and jewellery, wines and spirits.

Identifying companies in this industry with a strong brand, quality management and minimal fashion risk is key to investing in this industry.

Travel

The travel industry is highly discretionary and often subject to consumer behaviour and economic conditions.

Travel companies within this sector include those operating businesses such as hotels, resorts, cruises and travel services. Often these companies are sensitive to shifts in consumer spending, especially during economic downturns. Despite its susceptibility to economic pressures, this industry can also see significant growth potential. Factors like rising disposable incomes, trends towards spend on experiences rather than material goods and the rise of the middle class, provide ample opportunities for innovative travel companies to thrive.

Booking Holdings (Booking) operates within this industry, providing online travel and related services through its many brands – Booking.com, Agoda, KAYAK, OpenTable and Rentalcars.com. The company operates in over 200 countries and provides services in approximately 40 languages. It is also highly invested in technology and loyalty to enhance the customer experience. Booking has a diverse brand portfolio and an extensive distribution network, strategically partnering with airlines, hotels, car rental companies, and other travel service providers, providing customers with comprehensive travel solutions for multiple aspects of their travel needs.

Booking focus on the consumer experience has led to its presence as the largest travel platform globally, with repeat and direct customer engagement generating sustainable growth and strong returns for investors.

Retailers

Retailers in this sector include companies that sell products such as home goods, electronics and apparel. This industry can be highly sensitive to economic cycles with increased consumer spending during periods of rising economic growth. Companies include Lowe's, Home Depot and Amazon.



Bricks-and-mortar retailers have experienced a decline in foot traffic over time due to the shift towards e-commerce. This shift has compelled traditional retail stores to significantly adapt and enhance their online presence. Consequently, they have made substantial investments in technology to develop and maintain user-friendly websites and mobile applications, as well as to utilise artificial intelligence to improve the consumer shopping experience.

With this rise in online presence, the industry has had to optimise logistics operations to meet consumer demand for faster, more efficient shipping. Leading companies in this sector are those that can adapt to consumer preferences, foster customer loyalty, innovate in a dynamic market environment, and build a strong brand presence.

What are the risks?

Investing in consumer discretionary comes with risk like any other sector, thorough research and engagement with companies can help investors to understand these risks.

Economic sensitivity: This sector is highly sensitive to economic cycles. During downturns or periods of lower consumer confidence, consumers may cut back on discretionary spending, which can affect the sector's performance.

Consumer trends: The sector can be affected by consumer trends; for example, fashion trends. Brand strength is a key factor in offsetting the fashion cycle.

Competition: The sector can face intense competition, and companies must continuously innovate to attract consumers and maintain market share. Researching and understanding the long-term outlook for a company's innovation path and growth are important when investing in this sector.

How do consumer discretionary companies fit into a portfolio?

Including consumer discretionary stocks in a portfolio can provide potential growth opportunities. These companies often perform well during economic recoveries and expansions. While they may experience more volatility, quality discretionary companies can often be resilient and great compounders over time.

Examples of global listed consumer discretionary companies



McDonald's was founded in 1954 and has become one of the world's leading food service brands with more than 36,000 restaurants in more than 100 countries.



Nestlé, founded in 1866 is one of the world's largest food and beverage companies. The company operates in over 180 countries, offering a wide range of products including coffee, bottled water, dairy, infant nutrition, pet care, frozen foods, and confectionery.



Yum! Brands operates brands KFC, Pizza Hut, Taco Bell, and The Habit Burger Grill and has approximately 1,500 franchisees operating more than 55,000 restaurants in over 155 countries and territories.



Amazon was founded in 1994 and headquartered in Seattle. Amazon has grown into one of the world's leading technology companies, offering a vast range of products and services, including e-commerce, cloud computing, and digital streaming.

As at December 2024

What sets our approach apart?

There are thousands of companies listed on world exchanges. However, at Magellan we regard our eligible universe of potential investments to be only about 200 companies. These are the companies we believe to be of sufficient quality to consider for investment, companies in which we have a high degree of certainty in their ability to protect and grow earnings into the future. This requires rigorous fundamental research into the economics of the company and a deep understanding of the company's strategic direction and the industry in which it operates.

At Magellan, this focus on quality companies represents the core of our investment philosophy and goes directly to achieving our investment objectives for our investors.

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