Inside the Psyche of the Connected Consumer

Disruptive Forces in Investing

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Anu Rajakumar: As the current inflationary environment around the world remains top of mind, we look to the consumer; and how spending trends might allow us to stabilize the global economy. Generation Y, better known as Millennials, has surpassed Baby Boomers as the largest generation in our history, and Generation Z is proving to be the most racially and ethnically diverse group ever. So as population footholds shift, which generation holds the most spending power, and what goes on in the psyche of today's consumer at large?

My name is Anu Rajakumar and today, I'm excited to chat with Kevin McCarthy and John San Marco, senior research analysts and portfolio managers covering the consumer sector who have described consumer behavior as a megatrend that investors need to be aware of. Kevin, John, thank you for joining me on the show.

Kevin McCarthy: Thank you, Anu.

John San Marco: Great to be here. Thanks.

Anu: So, just to get us started, Kevin, tell us why you think consumer behavior is a megatrend, and what does that really mean?

Kevin: Understanding consumer behavior as a megatrend may seem foreign to some, but it's helpful to first understand what makes this demographic shift so unique and compelling. There are two pieces. The first is scale, and this is size. There are two back-to-back Baby Boomer size generations coming into their peak spending years over the next decade and a half.

These generations will have purchasing power equating to, roughly, three times the overall population. And then the second point is something that we call behavioral cohesion. If you think about it, these generations are the first digitally native cohort. So by default, they're more connected, they're more global, and they're more diverse.

Now, our objective is to understand what makes these cohorts or consumers tick by watching non-commercial behaviors and then trying to identify which companies are best positioned for market share gains over the longer term.

Anu: Right. That's excellent. Thank you very much. Now, you mentioned behavioral cohesion and, these generations are the first digitally native (DN) cohorts and, you know, related to that, data science has been transformative in understanding and predicting consumer behavior. So, I'm just curious, how do you use data science in your process?

Kevin: Sure, it's a great question. There are a lot of big words thrown around when we talk about data science, but the goal of our data science effort is-is really quite simple. We're trying to predict future wallet share. And to do this, we monitor current mind share through a process of scrubbing a lot of data. In particular, we scrub six terabytes of data daily.

What this means is we use internally developed algorithms to listen to what the DN cohorts are saying, what's important to them? What they like? What their dislikes are? And then we use a different set of algorithms to help us find which companies have overlap with these trends. Now, I could give you a few examples. One is travel, for example. Previously, understanding how to pick travel stocks in this area was a function of just isolating the second derivative of leisure travel rate growth. That's always been the key barometer for understanding where the kind of pivot point with the consumer is.

However, if we look at the last three years, you've seen a blurring of the lines between leisure and business. So now, as opposed to just looking at weekly travel trends, we zero in on daily data. We're looking at pricing trends on a specific day of the week. We're also looking at specific banners or flags or brands to understand which brands are benefiting most from loyalty use. And there are quite a few of other examples that we use. This isn't exhaustive, but John has a few other examples he could provide.

John: Yeah, great, Kevin. maybe I'll offer three other examples to bring it to life. First we're really focused on purchase intent data. It helps us to see the future to-to skate where the puck is going. And, you know, for example, we might look at web traffic or search data to see what it is consumers are focused on, what they're doing with their time, what they're thinking about.

A great example to bring that to life would be, we saw the consumer's online behavior begin to reveal less interest in all things related to their home as the world reopened after COVID. And so we were able to avoid that sector and, you know, and anticipate slower trends in home-related spending.

Another great example is just around tracking inventory, in retail, and very much related the amount of promotion and discount that goes on to, for retailers to clear that inventory. We're at this really unique moment in time where after two years of retailers not being able to get enough supply, now they have far too much, and it's going to be very painful and costly to work through that.

So alternative data helps us keep an eye on how we're progressing through that oversupply. Then maybe a third example, and by no means is this list exhaustive, but something else we're watching is just the stomach share between, food at home and food away from home. Historically, food away from home or restaurant dining has been highly correlated to how the consumer's feeling overall. It's a really easy part of the wallet to pull back on when the consumer is not feeling, so robust and, you know, eat at home more to save some money. And so we're watching that volume share or stomach share as we call it very closely too.

Anu: Yeah. I like that stomach share. I actually haven't heard that one before, so that's a good term. It's helpful to hear about how some of the consumer behaviors have shifted in a post-pandemic world. Just to, expand on that a little bit. I'm curious about what the current market dynamics, are at the moment, and what kind of generational difference is that you have been seeing, with regard to spending patterns?

Kevin: Sure, Anu. There certainly is quite a bit of volatility in the market. We like to simplify it down to kind of three different perspectives. First, you have the near term. And in the near term, there is quite a bit of economic uncertainty due to the dual pressure of lapping stimulus and then also the inflation.

So you have roughly 200 million consumers that are feeling cash flow strapped this year. So as that occurs, you're naturally seeing a shift or from wants to needs. And then looking at it a little bit longer term, more over the medium term, the priority is to focus on companies with purchasing power. And to do this, we have a variety of tools that we use to assess this, everything from customer cohort retention, to customer level engagement, loyalty, and so forth to better understand which brands are winning, which brands can continue to push pricing power, and which brands have pricing elasticity.

John: Can I just clarify a point? Those metrics Kevin and I use, I think he said purchasing power, but meant pricing power. We look at those metrics to determine, does a company have the ability to raise their prices and pass along inflation to customers.

Kevin: Great addition, John. And then the last lens that we use is really looking at it from, as you mentioned in your question is, the generational differences. If you look at the digitally native cohorts, they tend to be more active in subscription models, in loyalty models. And these tend to be stickier business models, and because of the data value add that they add to the consumers, there tends to be a more holistic experience, which tend to resonate a lot more with this connected consumer cohort.

Anu: Okay, excellent. It's obviously we all know it's a very noisy macro picture out there. So now, John, practically speaking as portfolio managers, how do you apply this to actually picking stocks?

John: Sure. Well, in practice, at the moment, we're favoring opportunities that aren't dependent on the macro and the whole process, particularly the data science component Kevin touched on, is dynamic to allow for that.

Kevin had talked about non-commercial behaviors and, this use of data science is another application of that. Two years ago, for instance, consumers want to know everything there was to know about redecorating their homes or building a home office. These are behaviors you might expect in a strong consumer environment.

And today the data is showing us that the more retrenched consumer wants to find affordable leisure experiences or-or needs to catch up on their vehicle maintenance, more needs-based goods and services. And so our data science has identified that and sort of automatically seeks out what those next shifts, ought to be, and we position our investments accordingly.

And in many cases, and we can talk about some examples of these, there's a strong self-help element that a company we might invest in enjoys, and that, you know, that ought to have nothing to do with the macro or demand can be expected to be particularly stable or in some cases there's so much secular growth potential that even as the macro cycle comes and goes, there's still an opportunity for outstanding growth over any reasonable timeframe.

I should point out that underpinning all of this it's paramount that we maintain discipline around valuation and margin of safety, because a fair earnings multiple does change in real-time as interest rates move around or appropriate profit margin expectations move around, rather quickly, as we've learned from unexpected supply shocks or demand turbulence. And our job is to find securities that are mispriced enough that even if some of those exogenous factors work against us, there still ought to be compelling return potential.

Anu: All right, John, well, seeing as you open the door for me to ask this question, why don't you give a few examples of some of the companies that you've been looking at recently, and maybe describe some of their process tools that are enabling the future success for those companies?

John: Great yeah, I'll offer a couple, I'm sure Kevin may have a couple different ones. So, I think first Becle is very indicative of what it is we're trying to do. This is a Mexico based spirits company that owns Cuervo tequila and several other brands. They're in the enviable positioning of selling a high margin recession-resistant good. And that category, tequila, particularly, even more so than spirits broadly, is having very strong volume growth that's being driven in large part by this newest class of drinkers, the digitally native cohort we keep talking about. We also feel really good about Becle's ability to pass along inflationary pressures to consumers as all of the data we look at suggests they're doing a really nice job premium-izing their portfolio and remaining highly relevant with this key young adult consumer segment.

Perhaps a second example on the other side of the border, I'd say Warby Parker. You know, I think this is really a poster child for the thematic opportunity we're talking about today. They're so small in the grand scheme of optical retail with less than a 1% market share, but we estimate they have four times higher market share in the under 40-year-old crowd that bodes really well as they expand their store base and their core clientele is gonna start to turn that magical age of 40, where many of them are gonna need glasses in the years ahead. Kevin, you have a couple other examples?

Kevin: Yeah. Just wanted to jump on that last point in terms of names that are, you know, screened incredibly well and are thematic around this. Membership Collective is a name that comes to mind. Membership Collective is a portfolio of social houses, about 40 social houses around the world. It's a global portfolio. So it's incredibly trend right. It's focused on experiences. It's focused on, you know, this concept of belonging. However, the company's undergone a tremendous amount of execution challenges following Brexit, the war, COVID. So there continue to be challenges that this company is facing on an execution basis.

However, when we go back to the milestones and what John referenced in terms of maintaining discipline around, you know, we look at membership statistics, we look at retention data, we look at the waitlist, and all of those things are trending at record high levels right now. So while there may be some execution issues here, we kind of try to look beyond that to see, and to understand that this is a concept that will continue to resonate and grow with this emerging demographic.

Another example is DraftKings. As you may or may not be familiar, the United States legalized online sports betting in 2018, and DraftKings, emerged as one, as being one of the leading contenders there. This is a superb thematic growth concept. The stock, of course, has been volatile due to challenges with early days of the industry formation, but management has shown incredible discipline around maintaining and growing share profitably.

We've been following this industry for a couple decades and candidly it's a tough business to model, but having a management team that understands the trade-offs between growth and profitability, which we believe this management team does, is very important. And so as we take a step back from all the monthly volatility and whatnot, the market is actually emerging almost exactly in line with where we expected two years ago. So we think this is another example of a company being caught up in some of the market turbulence, but it does offer vectors for growth beyond what is beholden to the macro.

Anu: Okay, excellent. Thank you very much. Now, consumers are increasingly focused on environmental, social, and governance issues. And I know I personally am currently wearing clothes purchased from a website that had an entire section dedicated to sustainability of its product. So John, maybe tell us about how ESG affects consumer behavior and what are you seeing?

John: Sure. Well, it's so relevant to this theme around gen Y and gen Z. Every survey we review, every book we read on the topic, every alt data set we examine to understand the relevancy of ESG to these young folks' consumption, really confirms that young people want to do business with brands and with companies with whom their values align.

A great example of that is Ulta. They've had remarkable success. They launched a program that they call Conscious Beauty, which effectively enables consumers to walk into their doors and identify brands that share ESG attributes that are important to them, whether it's environmental friendliness or diversity, equity, and inclusivity, friendliness. And, it's been a terrific success to align their business with their customers.

Anu: So as we wrap up here, let's take into consideration everything that you've discussed so far. What I'd like to hear is what do you think the consumer looks like a decade or so down the line and what are the takeaways out there that we should keep in mind when we think about the outlook for the consumer space?

John: Sure. I'll tell you the way we sort of frame the forms of investment opportunities around this theme and perhaps that'll answer the question. You know, we sort of think of three main buckets. Number one, we think there's these investment opportunities where you have intergenerational virality. And so, for example, that might be like Snapchat. Might sound like a household name here in the US, but usage trends are quite nascent globally, growing really fast and the view there is just that early adopters are gonna pass this along to their peers and it'll continue to grow quite virally.

A second example is what we call generational exporting and that's the idea that the youth who tend to be early adopters tend to be more willing to experiment with innovation and so forth. These are opportunities where that youthful adoption precedes, the ideas mainstreaming. And so looking at the last decade, some really, clear examples would be concepts like Facebook or now Meta or PayPal. Looking forward, we think an idea like online dating or online sports betting that Kevin touched on are concepts that younger generations are quite comfortable with today and we expect them to continue to export those behaviors over time.

And then the third bucket is, we sort of refer to as the inevitable bucket. And these are opportunities where All we really need is for these two massive generations simply to get older and simply for time to pass. And I think, you know, the eyeglass example, tells that story really well. We just need 30-year-olds to turn 40 over the next 10 years and demand for glasses is gonna go up. Household formation and all the spending related to that is another kind of longer-term opportunity that strikes us as an inevitable.

Anu: All right. Perfect. Thank you very much. Now I can't let you both go without a bonus question. So, here's one that you are completely unprepared for. I would like for you each to describe a gift that someone gave you that you can never forget. Or on the other side, if you want, something that you have gifted to someone that was particularly memorable or special, and this does not have to have any monetary value contrary to our theme of consumer spending, but something special in your life.

Kevin: Well, I guess I could start that off. I was actually just in the process of cleaning out my third floor and I came across a letter from my grandmother and I, fortunately, kept a folder of all these letters and the wisdom that was in that letter was, you know, I guess it wasn't a gift per se. But, the wisdom that, she imparted on me, I think I probably got that letter when I was 15 and it meant nothing to me at the time. But rereading it at 45, you know, it prompted a lot of questions and curiosity and just the wisdom. So I'd have to say that was probably one of the more special gifts.

Anu: That is very special. Thank you for sharing.

John: That is wonderful. My wife and I have been married eight years. And if I'm not mistaken, one of the traditional anniversary gifts for, I guess, either years one through seven is, wooden, I believe.

Anu: Yeah.

John: And I think that was the occasion where she got me a jar of golf tee. She knows I love to golf, wooden golf tees.

Anu: Yeah.

John: And she wrote, I love you on every single one. Like, it must have been a thousand.

Anu: Oh my gosh.

John: I'm still playing with that same jar of tees many years later.

Anu: That's a nice reminder every time that you go to tee off.

John: Yeah.

Anu: Well, thank you very much for sharing both very special and sentimental gifts there. Kevin, John, it's been great having you on here to discuss this theme of consumers, which we can all relate to. I visited a shopping mall the other day, which was almost completely dead, and it reminded me about how, you know, trends are shifting all the time in our economy. But again, appreciate your insights, and, hopefully, we can get you back on the show again soon.

Kevin: Been a delight. Thank you, Anu.

John: Thanks so much, Anu.

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