TRINITY SMF

STUDENT MANAGED FUND

Consumer Discretionary Sector Report

2023-2024

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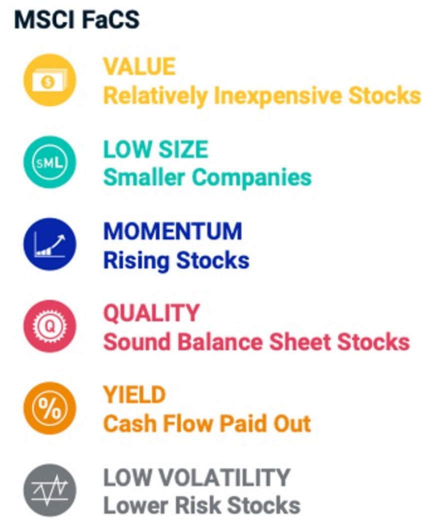
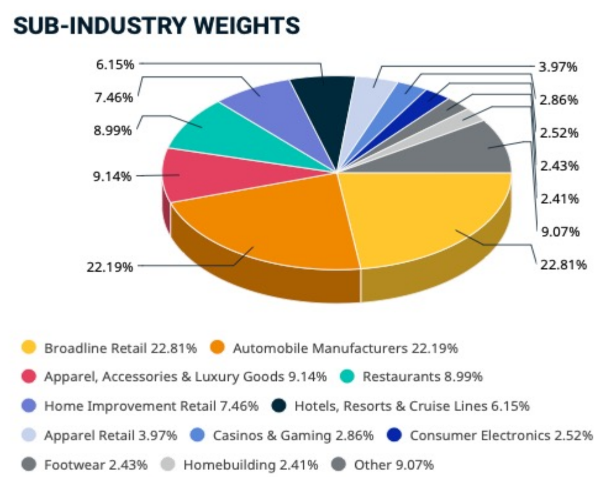
Sector Overview

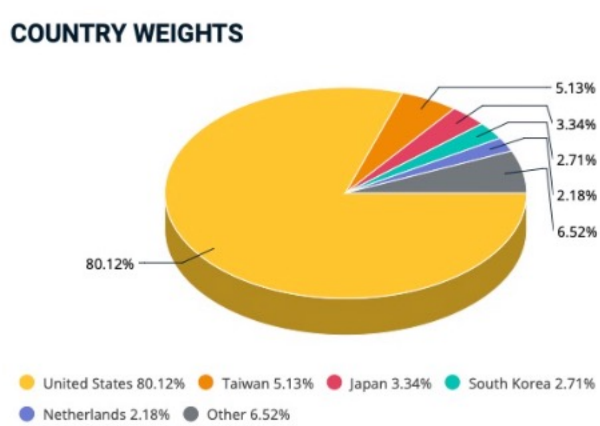
The Consumer Discretionary Sector encompasses a vast spectrum of industries catering to consumers' desires and preferences beyond essential needs. With a global market capitalization exceeding $6,793.4 billion, this sector spans entertainment, leisure, retail, and hospitality. Notably influenced by consumer sentiment and economic trends, the sector has historically displayed cyclical tendencies, with its growth intertwined with economic health.

However, a paradigm shift is underway. The infusion of technology and evolving consumer behaviors is reshaping the Consumer Discretionary Sector's landscape. E-commerce's remarkable ascent, for instance, has redefined retail by bridging the gap between traditional stores and digital marketplaces. Amid the COVID-19 pandemic, online shopping experienced an unprecedented surge, prompting companies to make significant investments in online platforms and supply chain optimization.

As the sector charts its future course, a moderate evolution is anticipated. While some subsectors may retain cyclical traits, technology's integration and the fluid consumer landscape offer the potential for increased resilience to economic fluctuations. Innovative products, personalized marketing, and enhanced consumer experiences are set to drive growth. To navigate this dynamic landscape successfully, companies must remain attuned to global trends, technological advancements, and shifting consumer preferences, underscoring the importance of robust research and development investments.







Key Players & Performance Indicators

Classifying companies in the broad Consumer Discretionary sector is complex due to their diverse segment involvement. However, prominent industry players emerge in various subsectors, including:

Luxury & High-End Apparel
Creates and delivers exquisite and premium clothing and accessories for discerning consumers seeking exclusivity and style.

- *Key Players*: LVMH, Kering, Ralph Lauren, Gucci, Prada
- *Key PI's*: Brand Equity, Global Consumer Sentiment, Market Share Growth

Entertainment
Produces and delivers engaging and captivating content spanning movies, TV shows, music, and digital media, catering to diverse audience preferences.

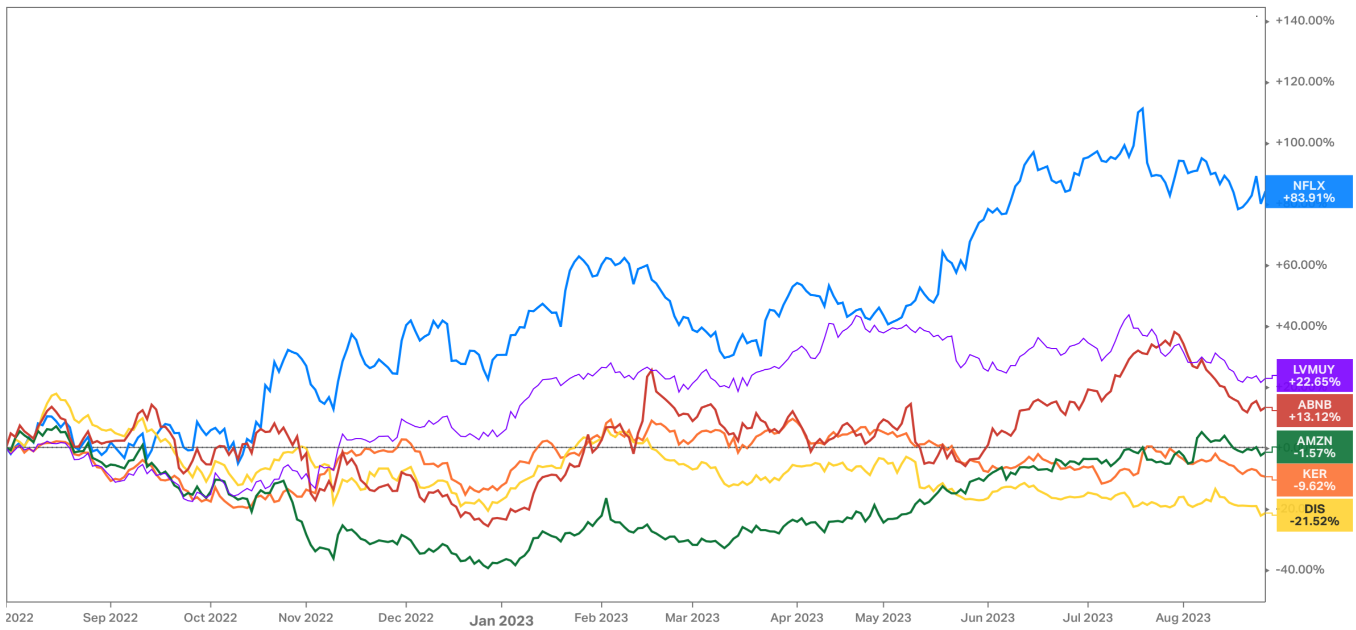
- *Key Players*: Netflix, Disney, Warner Bros., Universal Pictures
- *Key PI's*: Subscriber Growth, Box Office Performance, Content Quality, Content Catalog Size, Subscription Costs

Leisure Activities
Offers leisure and recreational services, ranging from travel experiences and theme parks to outdoor adventures, providing avenues for relaxation and enjoyment.

- *Key Players*: Carnival Corporation, Airbnb, Expedia Group, Hilton Worldwide
- *Key PI's*: Booking Volume, Customer Satisfaction, Adaptation to Travel Trends

Consumer Cyclical
Subsectors: Auto Components Industry, Automobile Industry, Distributor Industry, Diversified Consumer Services, Household Durables, Media

Current Climate



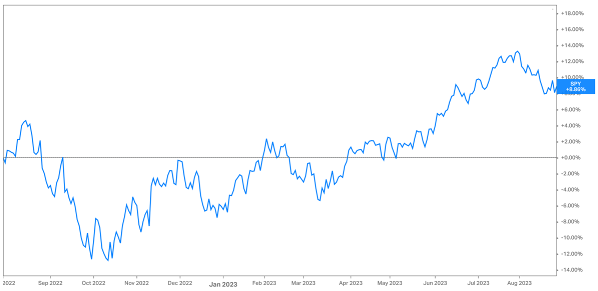
The consumer discretionary sector faced a challenging year in the past, marked by underperformance driven by economic uncertainties that deterred both consumers and investors from cyclical sectors. Looking ahead to 2023, the sector's performance still appears tethered to macroeconomic concerns. However, it's important to note that attractive stock valuations within the sector abound, with many companies demonstrating robust fundamentals. One notable segment within consumer discretionary, the home-improvement retailers, stands out with a compelling proposition. They offer a combination of enticingly low valuations and promising long-term drivers, including an aging housing stock and incentives for energy-efficient upgrades.

In 2022, inflation took center stage, significantly impacting consumer discretionary firms and squeezing consumers' budgets throughout the year. Simultaneously, consumer discretionary companies grappled with increased costs associated with manufacturing, transportation, and sales due to inflation. Surprisingly strong consumer demand and earlier supply-chain disruptions, coupled with labor shortages, allowed most companies to raise prices, often surpassing inflation levels, and pass on these heightened costs to consumers. Within this challenging environment, LVMH showcased resilience. In the first half of 2023, LVMH recorded robust revenue growth, with a 15% increase in revenue to €42.2 billion compared to the same period in 2022, driven by organic growth of 17%. However, it's worth noting that regional variations persisted, with strong performance in Asia-Pacific and Japan but some challenges in North America.

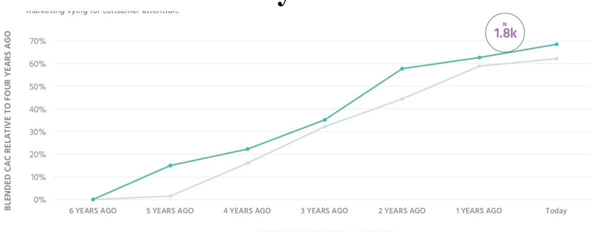
Key Player Performance

1) Netflix: +83.91%
2) LVMH: +22.65%
3) Airbnb: +13.12%
4) Kering: -9.62%
5) Alibaba: -7.90%
6) Disney: -26.92%

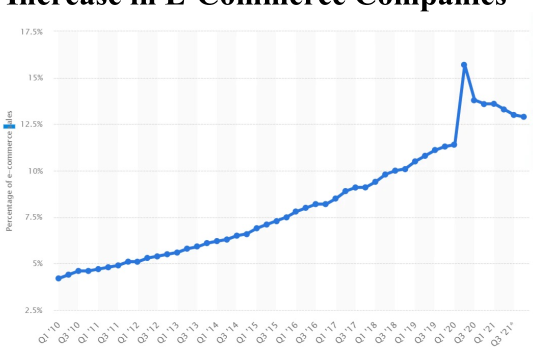
Consumer Discretionary Sector SPDR



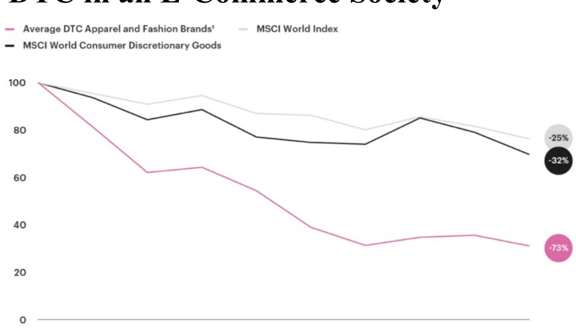
Customer Acquisition Cost has Increased Immensely



Increase in E-Commerce Companies



DTC in an E-Commerce Society



Integration of Brick-and-Mortar

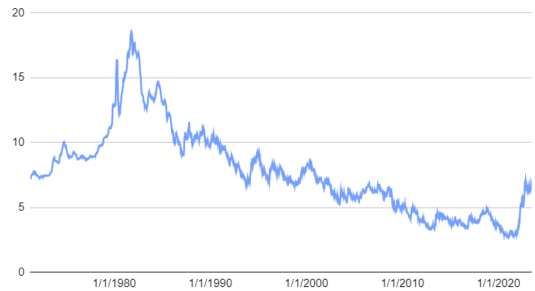
The integration of Brick-and-Mortar retail is emerging as a noteworthy investing theme in the consumer discretionary sector, emphasizing a strategic fusion of physical and digital shopping experiences. This trend recognizes the enduring value of physical store presence while leveraging technology to enhance customer engagement and convenience. Companies adept at harmonizing their brick-and-mortar establishments with digital platforms can tap into a diverse customer base, optimize inventory management, and offer immersive brand interactions, all of which contribute to potential growth opportunities within the evolving consumer discretionary landscape.

Direct to Consumers (DTC) in an ecommerce society

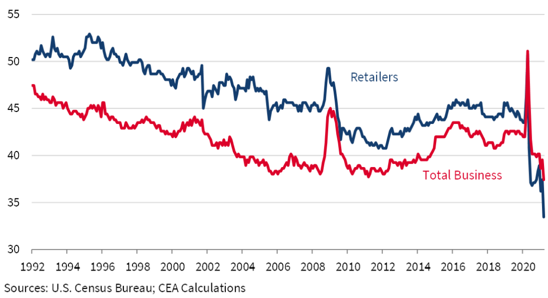
Direct-to-Consumer (DTC) strategies within the framework of an ecommerce-driven society have emerged as a compelling investing theme within the consumer discretionary sector. This approach allows businesses to establish a direct and personalized connection with their customers, bypassing traditional intermediaries. As consumers increasingly seek convenient and tailored shopping experiences, companies adopting DTC models can capitalize on this trend by enhancing brand loyalty, gathering valuable customer insights, and potentially achieving higher profit margins. Investors are recognizing the growth potential of businesses that harness the power of DTC in an ecommerce context, as it aligns with evolving consumer preferences and offers a strategic avenue for market expansion and competitive differentiation.

Priced in Sector Drivers

30-Year Interest Rates

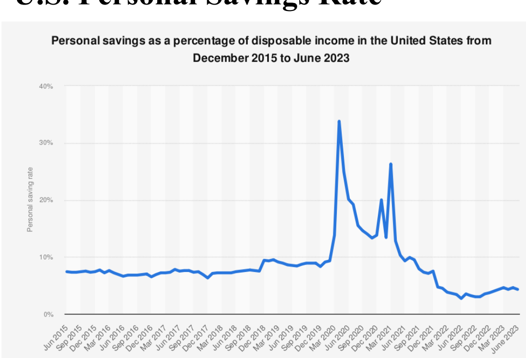


Inventory to Sales Ratio



OCED Consumer Confidence Index

U.S. Personal Savings Rate



Fed Response

Raising interest rates has cascading effects on borrowing costs for consumers and businesses, curbing demand, and aiming to counter inflation. The ongoing strategy of using rate hikes as a response underscores the Federal Reserve's commitment to maintaining stability, necessitating vigilant monitoring for desired outcomes.

Geopolitical Issues

Global events disrupt supply chains, causing shortages and pushing prices higher. European turmoil and COVID-19 outbreaks in China highlight how interconnected disruptions lead to inflationary pressures, demanding adaptability and international cooperation.

Labor Supply Shortages

Labor market structural issues, such as inactivity and sickness, create skill shortages, compounded by mismatched skills due to evolving industries. Addressing shortages and enhancing labor market resilience require investment in education, training, policy support, and skills development.

Consumer Confidence

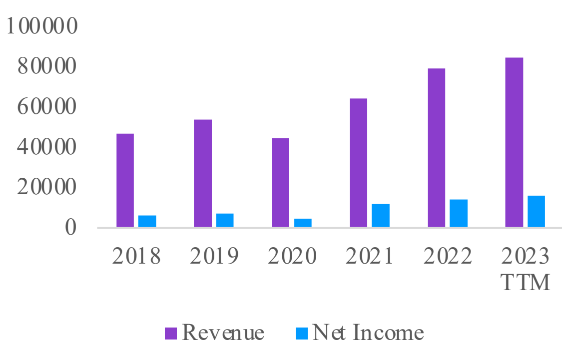
Improved consumer confidence, driven by real wage growth and a strong labor market, fosters spending and investment. Metrics encompass personal finances, job outlook, and purchasing attitudes. The rise of the Michigan Consumer Sentiment Index to 71.6 in July 2023, a slight dip to 69.5 in August, and its positioning between pandemic lows and pre-pandemic levels reflect the ongoing recovery. Positive sentiment bodes well for discretionary spending sectors.

Current Holdings – LVMH (Hold)

LVMH vs XLY

Share Price	€785.30
52 Week Range	€603.20 - €902.00
EV/EBITDA	14.9x
D/E	64.5%

Revenue vs. Net Income



*in millions

Analyst Consensus

Recommendations	**15-Sep-22**	**28-Aug-23**
Buy	9	8
Outperform	21	19
Hold	6	4
Underperform	0	0
Sell	0	0

Current Performance

In April 2023, LVMH reached a market value of €500 billion and reported a 13% profit increase, totaling €11,574 million. While the Asian market saw a strong 34% earnings rise, the US, contributing 25% to LVMH's revenue, experienced a 1% drop in Q2 sales due to reduced spending. Despite a remarkable 17% organic revenue boost in H1 2023, LVMH's profitable leather & fashion sector declined by 0.9% compared to 2022, citing factors like marketing costs and currency challenges. The wine & spirits division also struggled with an 8% revenue decline.

Expected Tailwinds

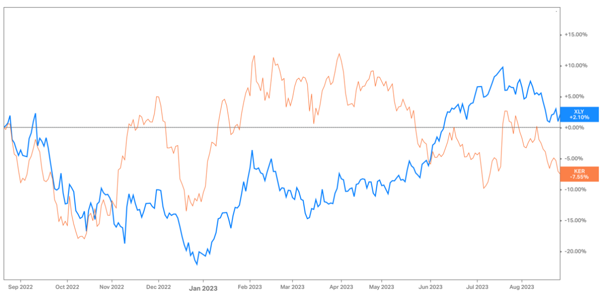
1. Middle-Class Customer Dynamics: Luxury retail's pricing flexibility, rooted in exclusivity and customer loyalty, can help offset production cost pressures, benefiting LVMH, particularly among wealthier customers less affected by inflation.
2. China Re-opening: China's post-Covid economic resurgence is a potential positive force for LVMH, a significant contributor to luxury spending. The rebounding Chinese sales and European tourism may boost revenues.

Expected Headwinds

1. Over-reliance on the US Market: Despite constituting 25% of revenue, the US market faces declining growth due to consumers cutting discretionary spending amid inflation, potentially challenging LVMH's diversified model.
2. Pricing Pressure: Luxury retail's sensitivity to spending fluctuations may require price increases to counter inflation-driven production costs, which could lead middle-class consumers to exit the market due to reduced income.

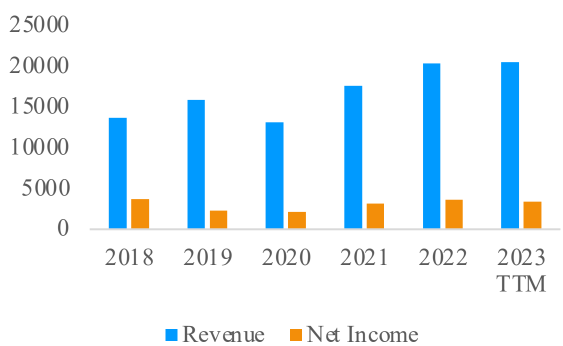
Current Holdings – Kering (Sell)

KER vs XLY



Share Price	€487.60
52 Week Range	€443.20 - €600.00
EV/EBITDA	9.6x
D/E	80.32%

Revenue vs. Net Income



*in millions

Analyst Consensus

Recommendations	15-Sep-22	28-Aug-23
Buy	6	4
Outperform	14	9
Hold	10	14
Underperform	1	1
Sell	0	0

Current Performance

Kering's performance in 2023 is characterized by slow revenue and sales growth. While the Asia-Pacific region, particularly China, enjoyed a 10% Q1 sales increase after lockdowns, the USA experienced an 18% sales drop due to reduced product appeal amid inflation-driven spending cuts. Gucci, their main brand, saw 1% Q1 growth impacted by a waning Chinese market appeal, while Yves Saint Laurent grew by 8%, Bottega Veneta remained steady, and Balenciaga struggled with a 9% revenue drop due to negative perception and reduced distribution. Kering's overall underperformance has prompted a decision to sell.

Expected Headwinds

1. Gucci Reliance: Kering's fate hinges on Gucci's performance; its recent decline contributes to Kering's issues, posing potential future challenges.
2. US Demand Decline: In 2023, US demand fell due to inflation-driven income fluctuations; prolonged inflation could harm sales, especially among middle-class high-end consumers.

Expected Tailwinds

1. Gucci's Audience Shift: Kering aims to boost Gucci through exclusive high-net-worth salons starting at $40,000, enhancing exclusivity and long-term demand, which could increase Gucci's brand exclusivity.
2. Valentino Stake Acquisition: Kering's 30% stake purchase from Mayhoola, with an option for full ownership by 2028, aims to strengthen ties and potentially lead to mutual investments for future benefits.

Case Study

Stellantis N.V. (STLA)

Stellantis NV was formed on Jan. 16, 2021, from the merger of Fiat Chrysler Automobiles and PSA Group. The combination of the two companies created the world's fifth-largest automaker, with 14 automobile brands.

Investment Thesis

1

Growing Demand for EV: In 2023, Electric Vehicles (EV) market revenue is projected at US$70.1bn, with a forecasted 2028 market volume of US$161.6bn and 2.46-million-unit sales. The expected annual growth rate (CAGR 2023-2028) is 18.17%.

2

Cost Competitiveness: As of 2023, preowned plug-in electric and fuel-cell EVs qualify for a credit of up to 30% of their purchase price, maxing out at $4,000.

3

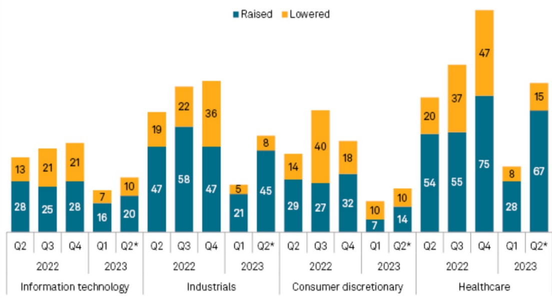
Stable Cash Flows: As of the end of 2022, the firm has already achieved EUR 7.1 billion in cash flow synergies, exceeding the original target two years ahead of schedule.

Financial Overview

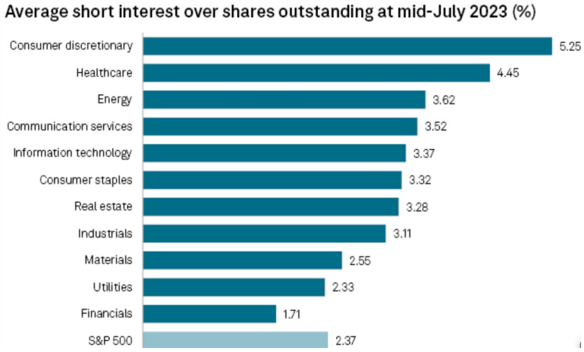
FYE, 12/31, €M	2018A	2019A	2020A	2021A	2022A	TTM
Revenue	110,412	108,187	86,676	149,419	179,592	189,961
Growth YoY	*8%*	*-2%*	*-20%*	*72%*	*20%*	*6%*
Gross Profit	15,401	15,023	10,714	29,476	35,265	38,565
% Margin	*14%*	*14%*	*12%*	*20%*	*20%*	*20%*
EBITDA	10,572	10,403	7,341	20,747	27,226	31,607
Capex	(5,392)	(8,385)	(8,600)	(10,113)	(9,014)	(9,052)
% of Revenue	-5%	-8%	-10%	-7%	-5%	-5%

Risks – Concerning Outlook

Number of raised and lowered corporate guidance announced by US companies in select sectors
Since Q2 2022

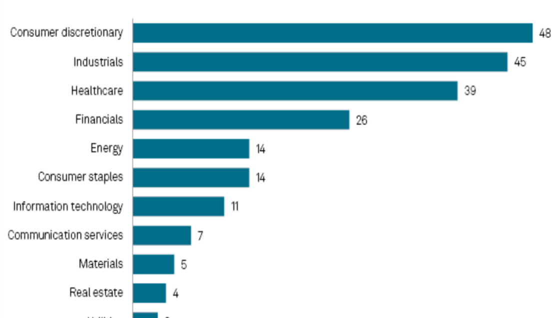


Average short interest over shares outstanding at mid-July 2023 (%)



Number of US firms with corporate guidance announcements, 2022-2023

2023 bankruptcy filings by primary sector



Inflation

Inflation significantly impacts the consumer discretionary sector by limiting spending on non-essential items due to rising prices. The Federal Reserve's tight monetary policies exacerbate this issue by reducing consumer purchasing power. In Q2, the sector posed risks for investors due to mounting inflation pressures and weakened consumer demand, particularly affecting nonessential businesses. During this period, 24 publicly traded consumer discretionary firms updated their forecasts, with 10 revising performance targets downward, constituting about 42% of the total, highlighting anticipated challenges.

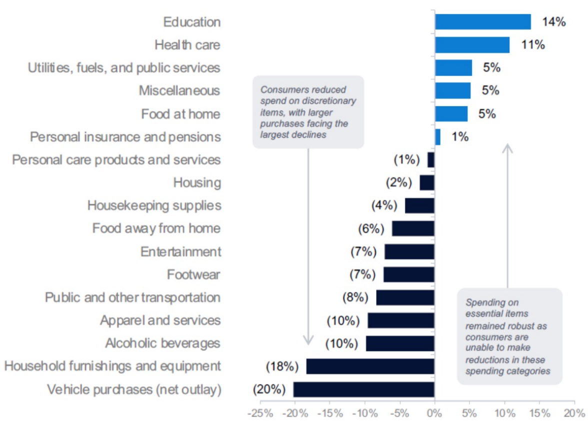
Interest Rates

Higher interest rates increase borrowing costs, dampen overall spending, and moderate inflation by reducing demand for goods and services. Additionally, these elevated U.S. rates attract foreign investment, bolstering the exchange rate. Short sellers, who anticipate stock declines, remain pessimistic about consumer discretionary stocks due to persistent high inflation and interest rates, potentially diminishing nonessential spending. With a 5.25% short interest, the consumer discretionary sector leads short selling by 80 basis points over healthcare, maintaining its 18-month record as the most targeted US stock sector. This trend underscores sustained skepticism in the sector's outlook, particularly concerning inflation and interest rate challenges.

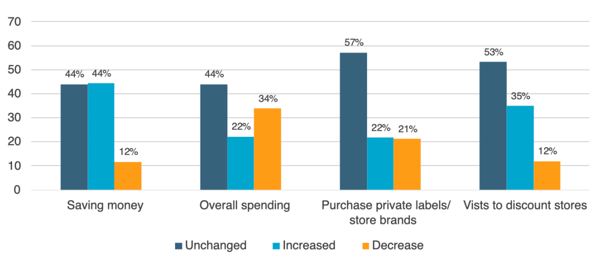
Corporate Guidance

Between the start of the second quarter on April 1 and June 23, twenty-four publicly traded consumer discretionary businesses issued updated corporate guidance, with 10 of them lowering performance targets — roughly 42% of the total. In comparison, 33% of companies in the information technology sector issued downgraded guidance in the second quarter, and 18% of companies in the healthcare sector did the same.

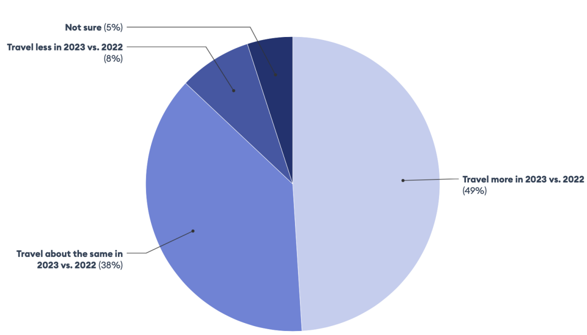
Change in Average Consumer Expenditure



How Consumers Plan to Change Spending and Saving



49% of Americans Plan To Travel More in 2023



Opportunities and Growth

Consumer Spending Shifts Amid Decline

Reduced consumer spending, driven by declining incomes, is reshaping consumption patterns. The 2008 Global Financial Crisis (GFC) offers insights into potential cutbacks, but the current context differs in key ways. Intensified spending competition now exists for items that were once classified as optional, such as electric vehicles, home automation systems, and wearable technology, all of which have now become integral parts of modern life for many individuals. Additionally, pent-up demand for post-COVID activities, like travel, is expected to impact other expense categories as travelers prioritize exploration into 2024.

Inflation Up and Greater Competition for Spend

Despite an economic slowdown, global inflation has surged due to rising food and energy costs. Projections show inflation at 6.6% in advanced economies and 9.5% in emerging markets. Supply chain disruptions and tight labor markets exacerbate this trend, while downside risks include potential European gas flow disruption, persistent high inflation, and emerging market debt distress. To adapt to the shifting consumer landscape, businesses must recognize the increased competition for spending in previously discretionary sectors like broadband, mobile, and streaming services. Furthermore, consumers may opt for cheaper alternatives as they face ongoing economic challenges, with surveys indicating a growing trend of 'trade-down' behavior. To retain customers and counter trade-down behavior, businesses must compete on value for money through offers and loyalty programs. Exploring companies that provide products at lower price points in discretionary sectors will be essential in this evolving landscape.