ETF Analysis: Consumer Staples

The consumer staples sector boasts some of the strongest business models, but investors should not ignore the lofty valuations of underlying ETF constituents.

Top Considerations

Vanguard Consumer Staples ETF (VDC)

Fidelity MSCI Consumer Staples Index ETF (FSTA)

Honorable Mention

SPDR Consumer Staples Select Sector (XLP)

VALUENTUM SECURITIES

July 17, 2017

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Consumer Staples ETF Industry Listings (sorted by AUM)

Name	Symbol	Launch	Gross Ex. Ratio %	Net Ex. Ratio %	AUM ($ - mil)
SPDR Consumer Staples Select Sector	XLP	12/16/1998	0.14	0.14	9,751.9
Vanguard Consumer Staples ETF	VDC	1/26/2004	0.1	0.1	4,500.0
iShares U.S. Consumer Services ETF	IYC	6/12/2000	0.44	0.43	813.6
Guggenheim S&P Equal Weight Consumer Staples ETF	RHS	11/1/2006	0.4	0.4	489.6
First Trust Consumer Staples AlphaDEX Fund	FXG	5/8/2007	0.61	0.61	484.2
SPDR S&P Retail ETF	XRT	6/19/2006	0.35	0.35	327.9
Fidelity MSCI Consumer Staples Index ETF	FSTA	10/23/2013	0.084	0.084	299.3
PowerShares Dynamic Leisure & Entertainment Portfolio	PEJ	6/23/2005	0.61	0.5	126.6
PowerShares Dynamic Food & Beverage Portfolio	PBJ	6/23/2005	0.58	0.5	124.2
PowerShares Dynamic Media Portfolio	PBS	6/23/2005	0.61	0.5	97.5
PowerShares DWA Consumer Staples Momentum Portfolio	PSL	10/12/2006	0.69	0.6	70.9
Market Vectors Retail ETF	RTH	12/20/2011	0.43	0.35	68.7
PowerShares S&P SmallCap Consumer Staples Portfolio	PSCC	4/7/2010	0.29	0.29	55.1
Direxion Daily Retail Bull 3x Shares	RETL	7/14/2010	1.14	1.05	24.9
ProShares Ultra Consumer Services	UCC	1/30/2007	1.33	0.95	21.3
PowerShares Dynamic Retail ETF	PMR	10/26/2005	0.88	0.63	13.4
ProShares UltraShort Consumer Services ETF	SCC	1/30/2007	2.77	0.95	1.9

Source: Relevant ETF Documents, State Street

Some of the Strongest Business Models

The consumer staples sector is renowned for having companies with strong cash-flow generating business models, sustainable competitive advantages, and popular product brand names. Constituents in the sector offer the basic necessities to consumers from food to personal products to cleaning supplies and beyond. We're talking about companies such as Procter & Gamble (PG), Coca-Cola (KO) Walmart (WMT), Altria (MO) and Pepsi (PEP) – steady-eddy entities whose products are in demand regardless of the economic environment.

In fact, these exact companies are held within the top 10 holdings of the two largest ETFs that track the sector, as measured by assets under management, the SPDR Consumer Staples Select Sector (XLP) and the Vanguard Consumer Staples ETF (VDC). The third-largest ETF in the sector, the iShares U.S. Consumer Services

ETF (IYC), takes a slightly different focus, showcasing more discretionary consumer services entities such as Amazon (AMZN), Comcast (CMCSA), Home Depot (HD), and Walt Disney (DIS) as a few of its top holdings at the time of this writing. The fourth and fifth largest ETFs in this group in terms of assets under management employ a differentiated strategy, with the Guggenheim S&P Equal Weight Consumer Staples ETF (RHS) opting for an equal weight approach, while the First Trust Consumer Staples AlphaDEX Fund (FXG) is even more unique.

Unlike its larger passive peers, First Trust's FXG seeks to track an "enhanced" index that ranks consumer staples firms of the Russell 1000 on price appreciation, sales growth, and value factors, including book value to price, among others. With aggregate fund constituents revealing a price-to-earnings multiple of nearly 20 times earnings, the FXG may lack any meaningful value bent for portfolio managers that place a greater emphasis on "true" underpriced stocks (as opposed to those that are only relatively more attractive to others within the same sector, as in the ranking process of the AlphaDex methodology).

We'd expect XLP's and VDC's returns to be highly correlated, and the FXG's performance to have a slightly higher degree of volatility given the potential for smaller cap positions to hold a higher weighting in the ETF. The median market capitalization of the VDC is ~$96 billion, for example, while the same measure for the FXG is ~$17 billion, revealing more of a mid-cap bent. From our perspective, those that are looking to track only the largest and strongest consumer staples equities may find the XLP, the VDC, or the Fidelity MSCI Consumer Staples Index ETF (FSTA) as the most suitable ideas.

As of the date of this writing, First Trust's FXG has heavy exposure to food products and retailing at ~66% of its holdings, and while the XLP, VDC, and FSTA have large exposure to that area as well, the relatively greater exposure of these three to the higher-yielding tobacco industry, for example, makes it a better idea, in our view. We generally prefer the more diversified industry exposure of the XLP, VDC, and FSTA and believe the strength and pricing power of the tobacco industry is a key advantage to owning steady-eddy consumer staples ETFs in the first place. The FXG, at any moment in time, may not put much weight in the industries that are most defining of the stable characteristics of the consumer staples sector.

Though the FXG has a few pitfalls, to be fair, it's worth noting that there's not much to differentiate the major positions of State Street's XLP, Vanguard's VDC, and Fidelity's FSTA (all three list Procter & Gamble as their top weighting between ~10%-12%). Their respective larger cap focus captures the strongest business models in the consumer staples sector, but the correlation between returns among these three ETFs will be quite high. From our view, the gem holding in the XLP, VDC and FSTA is ~7%-weighted Altria, which pays a healthy dividend and holds a large economic interest in AB-InBev (BUD), something the Street often overlooks.

In terms of future developments with respect to widely-held underlying constituents, investors in the XLP, VDC, and FSTA should pay very close attention to heavily-weighted Procter & Gamble's performance as the company looks to return to profitable top-line growth after considerable streamlining efforts of its portfolio. Investors should also be aware that PepsiCo's beverage and snacks business could be separated and that Walgreens (WBA) has recently enhanced its geographic diversification, bringing UK-based Alliance Boots into the fold. There's a lot going on in consumer staples these days, especially after considering the impact eCommerce giant Amazon has had in its disruption of the broader retail space.

In addition to being potential targets of activist investors, the group is heavily exposed to currency changes. Procter & Gamble and Coca-Cola, for example, could see several percentage points of top-line growth eroded due to foreign exchange fluctuations. Though movements in currency pairs may impact reported results, our general view with respect to currency impacts is that such a dynamic is net-neutral on the intrinsic value estimates of underlying ETF constituents. We wouldn't expect the strengthening of the dollar, for example, to influence a long-term investment decision, all else equal. In our valuation process, we target organic, currency-neutral operations as it is most informative to underlying business performance.

The biggest risk to the group, in our view, has little to do with the underlying fundamentals of the businesses, which are solid to a very large degree, but more due to the overall sector valuation. According to FactSet, as of July 2017, the forward 12-month price-to-earnings ratio for the consumer staples sector is roughly 20 times at the time of this writing, significantly higher than its 5-year and 10-year averages of 18.3 and 16.2 times, respectively. Most ETFs in the consumer staples universe, by last measure, are trading well above the market multiple, implying considerable "valuation-correction" risk. We attribute the present overpriced nature of the consumer staples sector to the elevated dividend yields.

Several of the top holdings in the consumer staples sector, for example, have been growing their annual dividends for more than 25 consecutive years. Clorox (CLX), Coca-Cola, Colgate-Palmolive (CL), Kimberly-Clark (KMB) and Procter & Gamble are but a few with long dividend growth track records. As a result of buyer interest for dividend growth reasons, we think the group's share prices have become more sensitive to interest rate changes than in prior cycles. The catalyst for downward price-to-fair-value convergence across the consumer staples sector may rest in contractionary monetary policy, as opposed to any underlying firm-specific factor. As the yields on riskless assets such as Treasuries increase, the dividend yields of risky assets such as dividend growth stocks become incrementally less attractive.

The largest dividend yields among consumer staples ETFs can be found in State Street's XLP, Vanguard's VDC, and Fidelity's FSTA. All three of these ETFs boast a dividend yield north of 2% at the time of this writing. Interestingly, however, many

of these ETFs' underlying constituents may offer a higher dividend yield, better total return prospects, and lower volatility than any one consumer staples ETF itself, giving investors a lot to think about. Readers should also bear in mind that chasing overpriced equities in search of dividend yield and business-model safety could lead to capital erosion and underperformance in the event that share prices ultimately "correct" to intrinsic value over time. Valuation can never be ignored.

But Which Consumer Staples ETF May Be Best?

Fund Top Holdings					
Vanguard Consumer Staples (VDC)		Fidelity Consumer Staples (FTSA)		SPDR Consumer Staples (XLP)	
Name	Weight	Name	Weight	Name	Weight
Procter & Gamble	10.00%	Procter & Gamble	11.06%	Procter & Gamble	11.99%
Coca-Cola	8.20%	Philip Morris International	9.11%	Philip Morris International	9.88%
Philip Morris International	8.10%	Coca-Cola	8.99%	Coca-Cola	9.19%
PepsiCo	7.30%	PepsiCo	8.10%	Altria Group	6.93%
Altria Group	6.30%	Altria Group	7.10%	Walmart	5.82%
Walmart	5.10%	Walmart	5.59%	PepsiCo	5.04%
Costco Wholesale	3.80%	CVS Health	3.98%	CVS Health	4.41%
CVS Health	3.70%	Walgreens Boots Alliance	3.52%	Walgreens Boots Alliance	3.78%
Mondelez International	3.50%	Costco Wholesale	3.30%	Costco Wholesale	3.72%
Walgreens Boots Alliance	3.50%	Mondelez International	3.27%	Colgate-Palmolive	3.60%

Source: Relevant ETF Documents

For cost-conscious portfolio builders, the lowest net expense ratios belong to Fidelity's FSTA at 0.084% and Vanguard's VDC at 0.10%, followed closely by State Street's XLP at 0.14%. First Trust's FXG has a net expense ratio of over four times that of the leaders. Other offerings, including the Guggenheim S&P Equal Weight Consumer Staples ETF (RHS), PowerShares DWA Consumer Staples Momentum Portfolio (PSL), and PowerShares S&P SmallCap Consumer Staples Portfolio (PSCC) have net expense ratios mostly in between those two extremes, and the ultra-leveraged consumer staples ETF products are even more expensive.

As with Vanguard's VDC, the low-cost FSTA boasts the heavyweights Procter & Gamble, Coca-Cola, Pepsi, Walmart and Philip Morris (PM) as a few of its top holdings, and we would expect a high correlation with the VDC and FSTA as a result. The FSTA's introduction seems to have been to attract assets seeking the lowest-cost option for consumer staples exposure, and it may have been the advent of a battle for the title of lowest-cost fund in the space as both the FSTA and VDC have lowered their expense ratios in recent years. By comparison, the FSTA's assets under management are relatively small at ~$300 million at the time of this writing. This, however, may be a result of its relatively recent launch date of October 2013 and Vanguard's competitive response more than anything else.

Though there may not be much to differentiate the XLP, VDC and FSTA, the higher expense ratio of First Trust's FXG doesn't appear to be worth the price, though we note the ETF continues to have more assets tracking it than the FSTA. The FXG could offer an option for investors that may not want exposure to Procter & Gamble

or Coca-Cola, the largest holdings in the bigger competing ETFs, but investors can probably do better than the ~0.60% expense ratio of the FXG by buying a basket of underpriced and strong-performing (good momentum) consumer staples entities themselves. We would expect the FXG to underperform its larger peers in a more difficult market environment, as the ETF neither has the embedded cushion of a larger-cap focus nor any absolute valuation considerations (i.e. price to fair value ratio).

State Street's XLP is the segment leader in assets under management by a considerable margin, which makes sense intuitively, as it is the oldest of the funds. When most investors think of ETFs, for example, "spiders" often are the first reference. Fidelity's offering is the latest addition to the group, and the ultra-leveraged products haven't gained much traction during the past decade or so. Speculative traders are moving in and out of the leveraged products on a daily basis, so we wouldn't expect much of an asset build over time.

There are a few other ETFs in the consumer staples sector that are worth noting. Guggenheim's RHS lacks a draw due to its relatively higher expense ratio. PowerShares' PSL could expose investors to overpriced stocks at their extremes given its momentum (sans value) approach, while the PowerShares' PSCC isn't attractive given its tendency for concentrated positions in small cap stocks. At last reference, the PSCC held only 18 stocks, which we view as too light of diversification for an ETF tracking consumer staples, especially for one whose fund characteristics reveal an average market capitalization less than $1.8 billion as the PSCC does. Unless investors have the inside track on the top holdings, exposure to these ETFs makes little sense in the context of most portfolio goals with this sector.

Long-term investors should be mindful of the risks embedded in ETFs promising returns of the 2x and 3x variety, including ProShares Ultra Consumer Services (UCC), ProShares UltraShort Consumer Services (SCC), and Direxion's 3x offerings. These highly-leveraged products provide a return that is several times the return of the benchmark index *for a single day*. Importantly, these ETFs should not be expected to provide the return of their benchmark's cumulative returns over longer periods of time. As a result, such ETFs should be viewed as mere trading vehicles, perhaps even hazardous to the individual investor unaware of erosion risk brought about by index volatility.

From our perspective, Vanguard's VDC and Fidelity's FSTA are the best options for investors looking to gain broad exposure to the consumer staples sector. These two ETFs include some of the strongest businesses as their top holdings, boast a robust dividend yield, and have the lowest net expense ratios in the group. Investors should be cognizant, however, that Fidelity's FSTA is still relatively new, and the ETF's track record has yet to be tested. We give State Street's XLP an honorable

mention. The XLP is tried-and-true and has all the qualities of the VDC, but is just a few basis points more expensive.

Several of the top holdings in the VDC, FSTA, and XLP are included or have been considered for addition to Valuentum's newsletter portfolios. For example, Procter & Gamble and Altria have been or are currently included in the Dividend Growth portfolio. The consumer staples sector is overflowing with some of the best businesses on the market today, but the lofty valuation dynamics of the sector shouldn't be sacrificed for dividend yield.

Valuentum Buying Index Ratings

We think the best ETFs are those that have low or reasonable expense ratios, have holdings that are collectively underpriced, and have technical and momentum indicators that are currently exhibiting bullish trends. Similar to how we arrive at the Valuentum Buying Index rating for stocks, we perform a process in arriving at a Valuentum Buying Index rating for each ETF.

The highest-rated ETFs will have best-in-class expense ratios, have undervalued constituents in aggregate, and possess strong technical and momentum indicators. The Valuentum Buying Index rating reflects our assessment of the relative attractiveness of each ETF on a scale from 1 through 10 (10 = best).

An ETF that registers a 5, for example, is relatively more attractive than an ETF that registers a 4 within its defined category based on the three defined parameters of "expense," "valuation," and "technicals." That same ETF can also be considered relatively more attractive to an ETF that registers a 4 in another defined category.

ETFs that register a 9 or 10 on the Valuentum Buying Index are not only best-in-class within their respective categories, but also may represent ideas for the opportunistic investor.

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