The Case for Buying What You Know and Need
Staples and the Power of the Prosaic

Introduction:

This paper adds to our **recent research** making the case that today is one of the most compelling times in history to adopt a simple **dividend and income investing strategy** in Consumer Staples. Specifically:

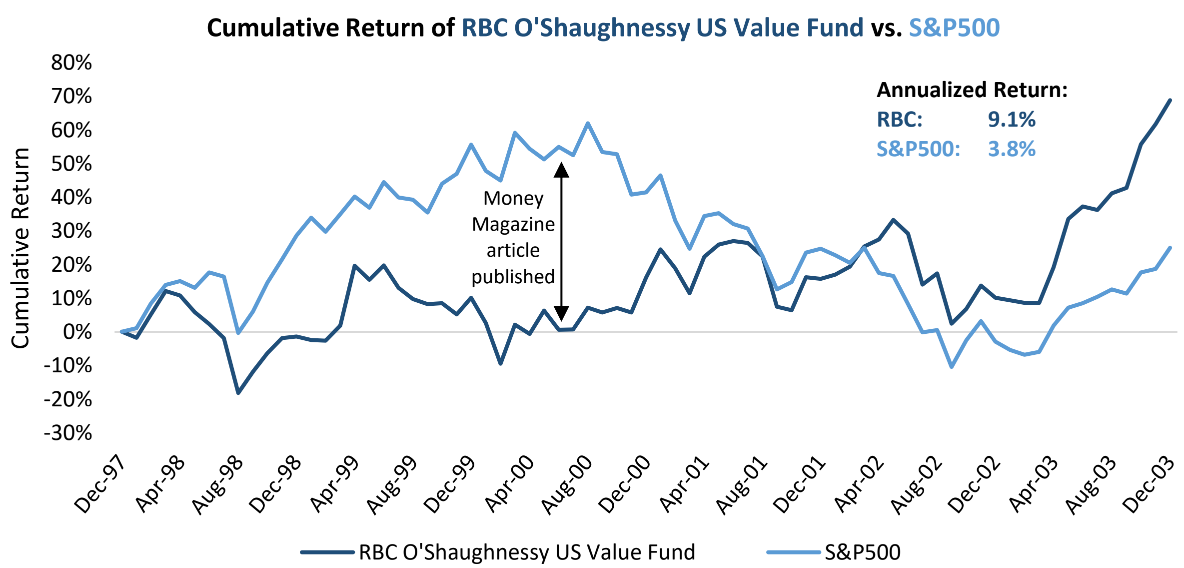
- **Mania:** Kailash has documented the myriad analogs between today and past manias that ended in disaster, embodied by this well-intentioned, if surreal, TikTok video about day-trading
- **Defense & Offense:** As a speculative frenzy drives markets, Kailash further documents Staples' long-prized defensive and offensive characteristics that seem to have been forgotten
- **Uncommon Opportunity:** Based on history, today is one of the most opportune times to buy Staples

In the back pages of legendary investor, thinker, and writer, James P. O'Shaughnessy's "*What Works on Wall Street*," the author noted that in July of 2000, Money Magazine wrote a critical article about him. Titled "*What Doesn't Work on Wall Street*," the magazine asserted his systematic approach to investing "…doesn't seem to work anymore."[1] Reflecting on this and other public attacks levied at him in 2000, O'Shaughnessy wrote:

In feverishly speculative markets, believing in Occam's razor – that the simplest theory is usually the best – is almost impossible. We love to make the simple complex, follow the crowd, get seduced by some hot 'story' stock, let our emotions dictate decisions, buy and sell on tips and hunches….

From December of 1997 through the date of Money Magazine's July 2000 article, the Fund run by O'Shaughnessy today was up less than one percent vs. the S&P, which had risen 53%. From July 2000 – December 2003, the S&P would fall 18% while the Fund would soar 67%. Looking at the whole period, 1997 – 2003, the Fund compounded loyal investors' money at 9.1% annually vs. only 3.8% for the Index. "*What Works On Wall Street*" was a formative part of this writer's upbringing, and I would like to thank Jim for his fantastic work. Kailash would also suggest that recently minted day-traders might find buying (and reading!) a copy of his book the best investment they make in an environment like this.[2]

Fig. 1: RBC O'Shaughnessy US Value Fund Performance vs. the S&P500, 1997 - 2003



Source: Kailash Capital, RBC Global Asset Management, Compustat; Data from 12/31/1997-12/31/2003

[1] *What Works on Wall Street, James P. O'Shaughnessy, Third Edition, page 379*
[2] Email info@kailashconcepts.com and Kailash will ship a complimentary copy of *What Works on Wall Street* to any Premium or Enterprise subscriber

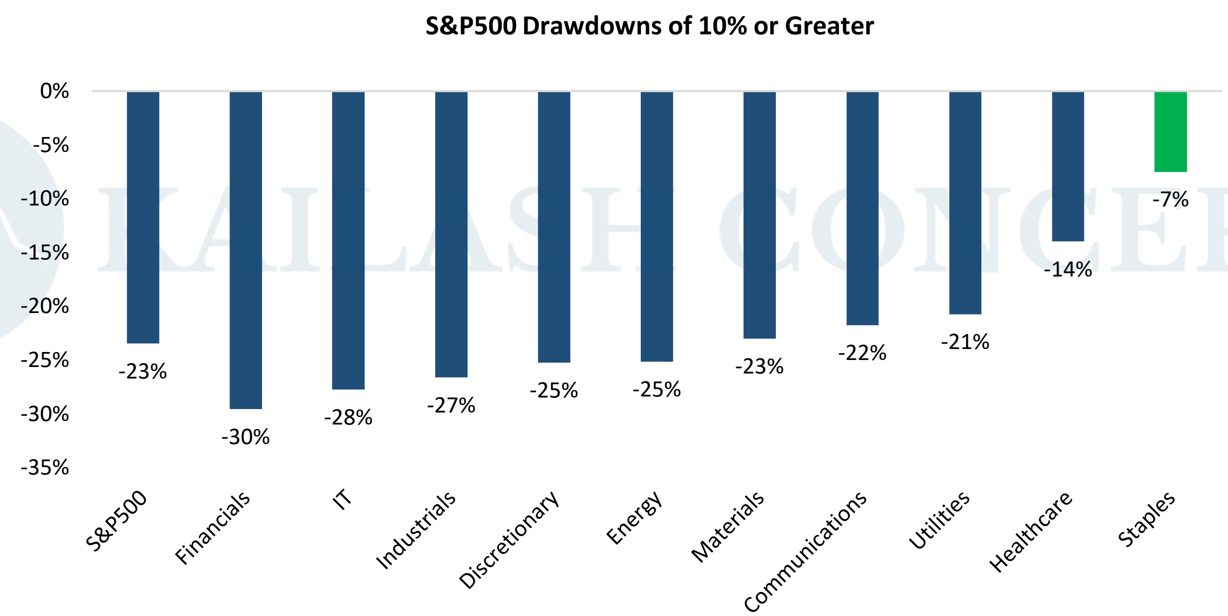
Defense & Offense: The History of Sector Performance in Market Crashes

Kailash believes the analogs between today and prior manias, particularly the internet bubble, have now been documented such that further evidence need not be produced. If you feel differently, please reach out to info@kailashconcepts.com and let us know why. We are open-minded and welcome dissenting views. For those who agree that many stocks are in nosebleed territory today, that this time is **not** different, and are concerned about capital preservation and income, Kailash believes Staples is part of the solution.

Our **last piece** suggested investors might be well served to rotate out of loss-making IT and into Staples. As evidenced below, our belief today is that the best defense happens also to be the best offense! Figure 2 shows the performance of the S&P500 and each sector in all market declines of 10% or more.

Looking at the first bar, you can see that when the S&P500 declines by -10% or more, the average decline is -23%. The bars to the right of the S&P500 show each sector's performance in these periods sorted by worst (Financials, -30%) to best (Staples, -7%). What stands out to us is that in these sharp corrections, there is very little dispersion between the first eight sectors. In the history of panics, five of the sectors did slightly worse than the S&P500 (Financials through Energy) while three fell by nearly the same amount (Materials through Utilities). **In contrast, Staples has a long track record of capital preservation in crashes, declining by only 7% when the rest of the market collapses.**

Fig. 2: Staples Prove their Mettle in Market Corrections with Fantastic Downside Protection

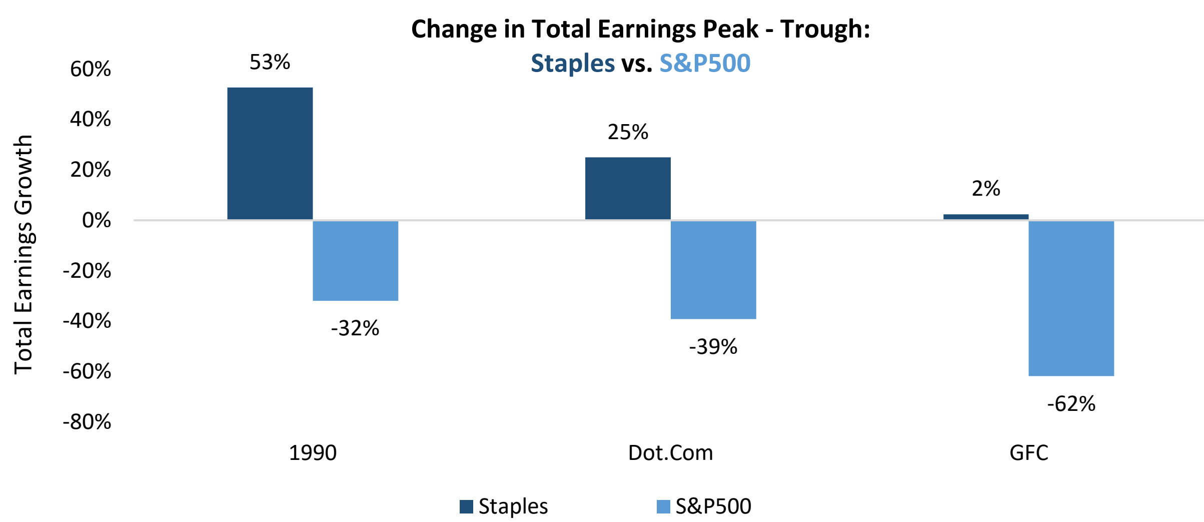


Source: Kailash Capital; Data from 4/30/1989-12/31/2020

Defense & Offense: The History of Sector Performance in Market Crashes

The fundamental reason Staples did so well in corrections is they possess a great deal of cyclical immunity. Figure 3 below shows the change in profits for Staples (navy blue bars) and the market (light blue bars) from the peaks to troughs. Looking at the right two bars is possibly the most instructive. From the peak in profits to the trough brought about by the Great Financial Crisis (GFC), Consumer Staples actually **grew** their profits +2%, while the Index collapsed as earnings fell a terrifying -62%.

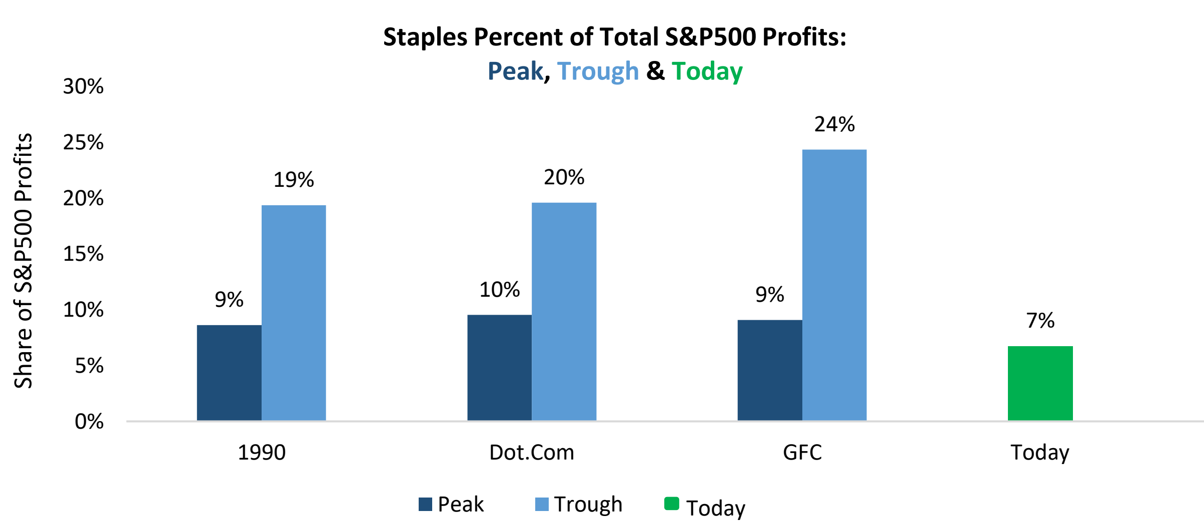
Fig. 3: From the Peaks to Troughs of the Market's Profits, Staples Are Consistent



Source: Kailash Capital; Data from 4/30/1989-12/31/2020

Figure 4 below shows this same concept in a slightly different way. Using the same starting dates as above, Fig. 4 shows the percentage of **total index profits** from Consumer Staples. We will use the last set of blue bars, the GFC, as an example to make our point. Staples made up 9% of total profits in the index at the peak just before the GFC collapse. By the time the profit cycle troughed, Consumer Staples made up a stunning 24% of **total index profits.** The final bar in green shows that at the moment, Consumer Staples make up only 7% of total index profits (a bottom decile historical occurrence since 1989). History suggests another down cycle is coming as the "Golden Age of Fraud"[3] eventually comes to a painful end as it always has.

Fig. 4: Percent of Total S&P500 Index Profits Derived from Staples at Various Peaks and Troughs



Source: Kailash Capital; Data from 4/30/1989-12/31/2020

[3] https://www.ft.com/content/ccb46309-bba4-4fb7-b3fa-ecb17ea0e9cf ; Jim Chanos: "We Are in the Golden Age of Fraud"

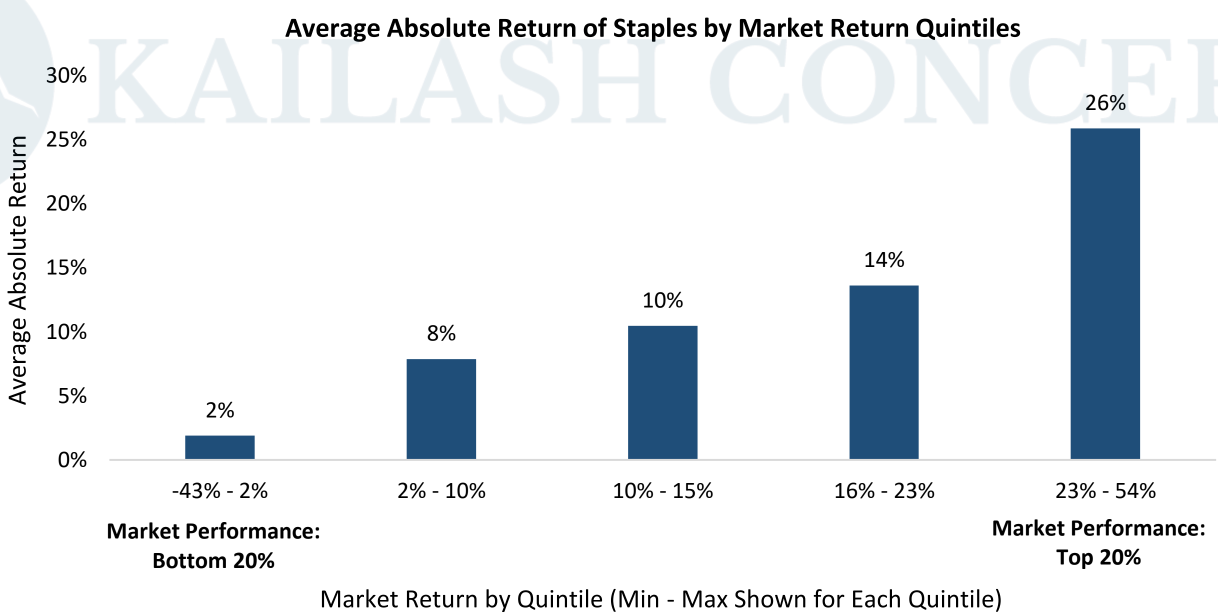
Defense & Offense: Staples are the "All-Weather Tire" of Equity Investments

One of the many reasons Kailash chose to focus on Consumer Staples was that the sector is largely comprised of some of the longest-lived, most profitable, and durable franchises around. Fig. 2 above made it clear that Staples provided powerful downside protection. Over the next few pages Kailash will provide what we believe is compelling historical evidence that playing Staples also offer a smart and simple **offense** in periods like today. **Summarily, Kailash believes Consumer Staples are akin to a terrific all-weather tire – providing not just solid traction when the terrain becomes precarious like today but also performing admirably in a wide range of markets.**

The most general evidence of this can be found in Fig. 5 below. Kailash cut the S&P500's historical 12 month rolling performance into quintiles and arranged them from the bottom 20%, on the left, to the top 20%, on the right. Each bar shows the average performance of Consumer Staples in these periods. The first bar on the left shows that in the worst quintile (20%) of market performance, the S&P500 declines by -43% to -2%, yet Staples are actually **up** 2% on average during these periods. This is, of course, consistent with Fig. 2, which shows that Staples do well in difficult times.

Looking at each subsequent bar, what stands out is that Staples put up very solid absolute returns **regardless** of the market environment. Looking at the right-most bar, for example, shows that during the stock market's best quintile of returns, the Index rises between 23% and 54%. Staples are up "only" 26% on average during these periods. One can easily infer that when the market is flying higher, as it is now, Staples lag the Index. As we will show in the following slides, what Staples give up during the market's most manic 12 month periods is more than compensated for over longer investment horizons.

Fig. 5: Staples are Stellar in Down Markets and Solid Across All Market Environments



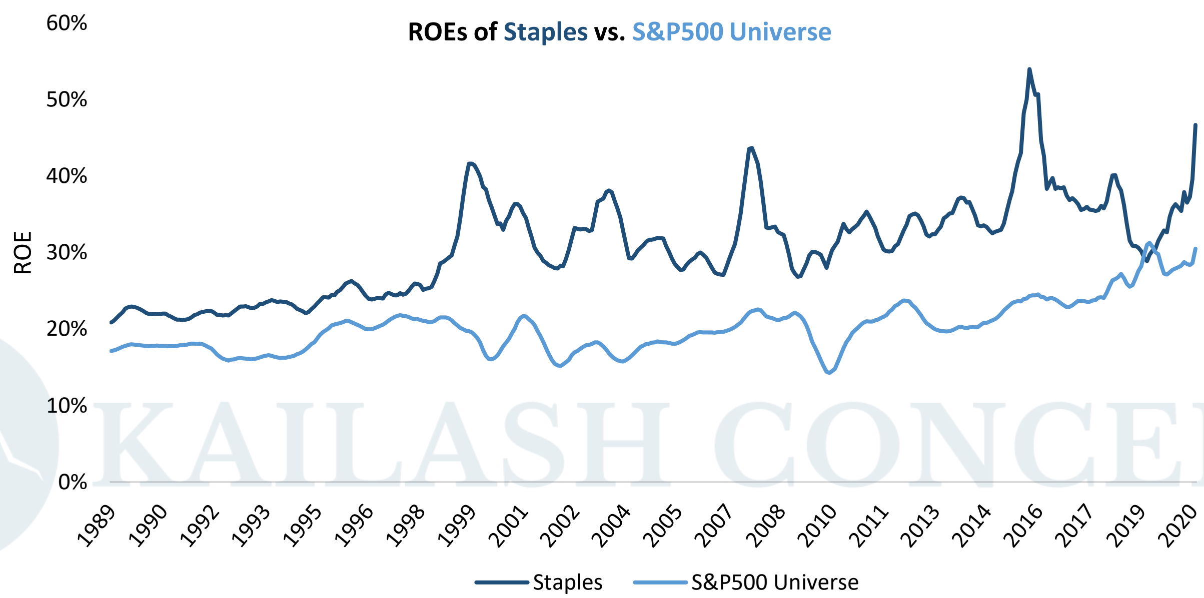
Source: Kailash Capital; Data from 4/30/1989-12/31/2020

Defense & Offense: Staples are the "All-Weather Tire" of Equity Investments

Suppose one had to summarize the reason Staples do so well in down environments. Kailash believes it is the intuitive and historical fact that during recessions or declines from speculative excess, people still buy basic goods. They are the classic embodiment of firms with very low levels of sensitivity to economic and market cycles. Figure 6 confirms this intuition. Looking at the period following the two biggest corrections over the last 30 years, the collapse of the internet mania and the GFC, the Index suffered sharp declines in ROEs.

In our view, what is even more striking about Fig. 6 is that ROEs for Consumer Staples are reliably higher than the market over the entire history. As we will show, the market almost always rewards Staples with premium valuations, but when it fails to, investors have been richly rewarded by buying these economic stalwarts.

Fig. 6: Staples ROEs are Consistently Higher than the Broad Universe ROEs



Source: Kailash Capital; Data from 4/30/1989-12/31/2020
*Data is an average 6m smoothed ROE

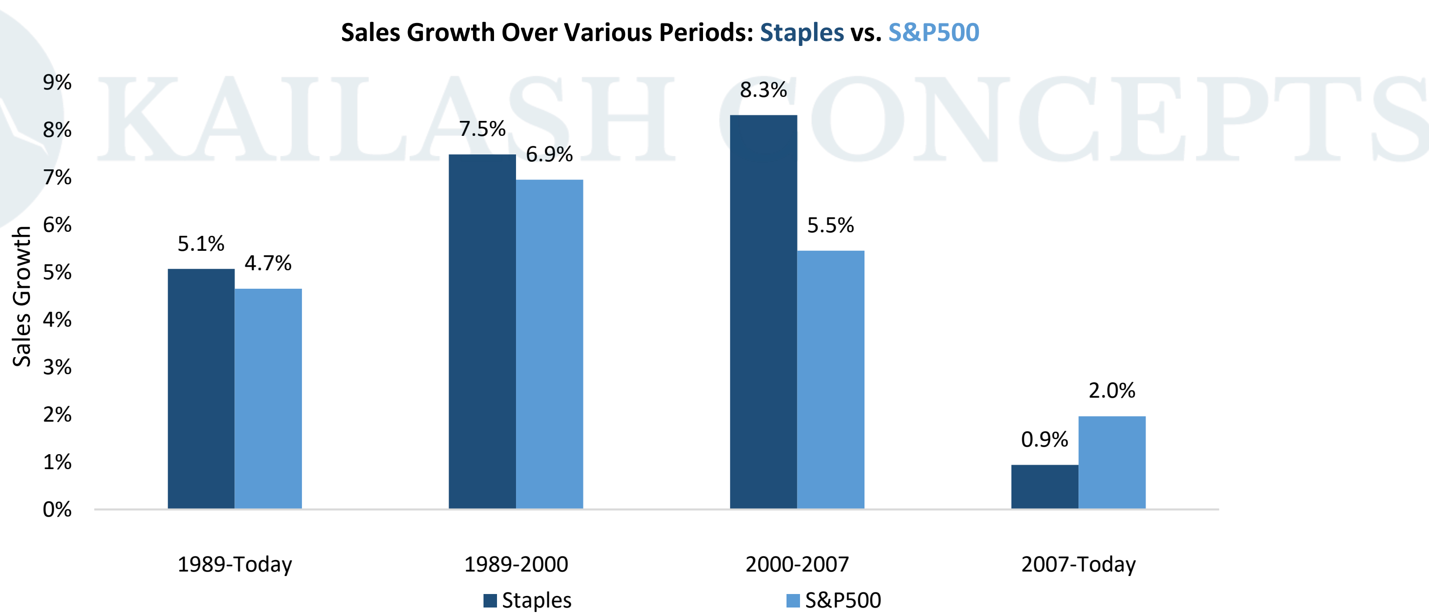
Defense & Offense: Staples are the "All-Weather Tire" of Equity Investments

In rare periods like today, Staples are shunned by markets as investors "make the simple complex" and begin chasing the "shiny objects." Who wants to buy a company that makes a *passé* product like cigarettes or something as prosaic as diapers? Your neighbor just doubled their money buying a SPAC or calls on an IPO of a firm they didn't even understand! Even for more sophisticated investors, Staples may look "stodgy" when compared to the sexy top-line growth that has mesmerized markets today. Despite bleeding cash, firms like Carvana soar on the back of rising revenue growth when, in fact, no rational DCF that we have seen can begin to justify the price.

Figure 7 below shows that Staples match the market when it comes to revenue growth over time. As noted above and in our research **How to Build a Growth Stock** and **The Persistence of Profits** maintaining above-average growth rates is exceedingly difficult and, today, frequently accompanied by a lack of profits. The first two bars show that Staples have grown revenue from 1989 – Today, just as fast as the overall stock market. Even from 1989 to the peak of the internet mania in 2000, Staples matched the market's growth rate. Looking at the third set of bars, from peak to peak (2000 – 2007), Staples actually grew 3% faster than the market.

Finally, looking at the last two bars, from the peak in 2007 through today, Staples have grown nearly as fast as the market. This despite the fact that many firms are pursuing revenue growth strategies that require losses and are unsustainable. Kailash believes the decline and collapse of some of the market's most richly valued "story" stocks is inevitable. Similar to the post-2000 precedent we believe Staples will compound sales growth at a rate that will eclipse that of the broad market.

Fig. 7: Compound Rate of Sales Growth: Staples vs. S&P500



Source: Kailash Capital; Data from 4/30/1989-12/31/2020

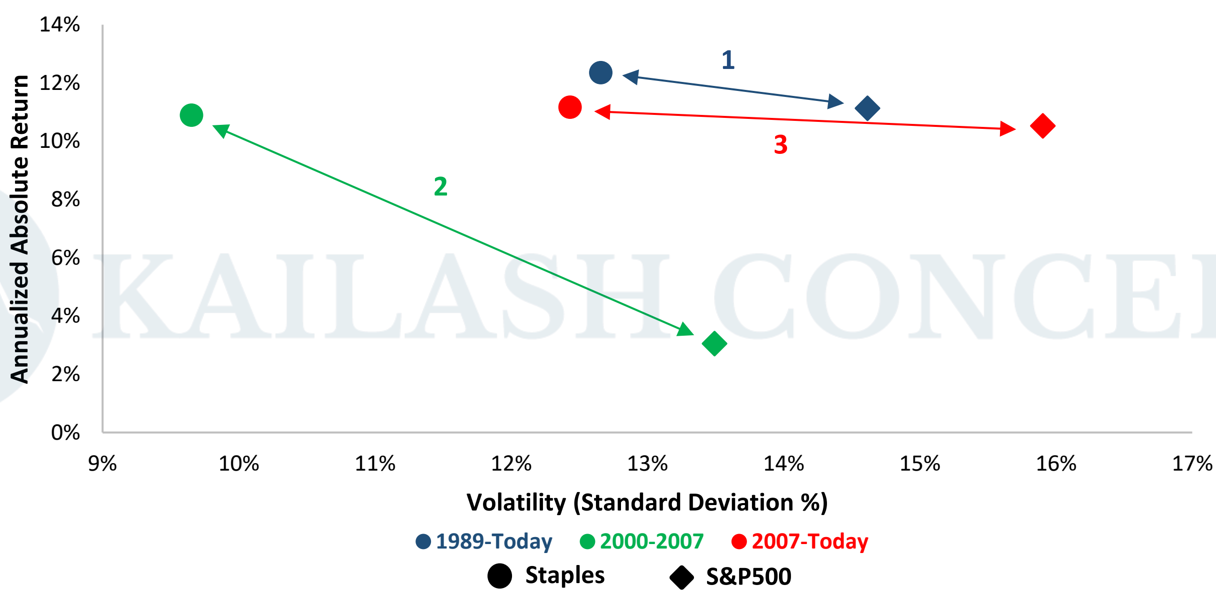
Defense & Offense: Staples are the "All-Weather Tire" of Equity Investments

Figure 8 below is the actual market outcome for all the points made above. We have plotted the returns on the vertical axis and the volatility on the horizontal axis for Staples (circles) and the S&P500 (diamonds) over three periods. Kailash believes the chart speaks for itself but will highlight the following:

1. Comparing the **blue circle** to the **blue diamond**, over 30 years of history, Staples have provided equal to higher returns than the broad benchmark with lower volatility
2. Comparing the **green circle** to the **green diamond** shows that staples generated 10% average annual returns from 2000 – 2007 with less than 10% volatility, while the broad Index earned a paltry 3% and experienced over 13% volatility
3. Looking at the **red circle** and the **red diamond**, from 2007 – today, Staples have held their own with a fraction of the market's volatility

Kailash believes this serves as compelling evidence that Staples have been some of the best firms for investors at any time – particularly on a risk-adjusted basis.

Fig. 8: Annualized Absolute Return & Volatility of Staples & S&P500 Over Various Time Horizons



Source: Kailash Capital; Data from 4/30/1989-12/31/2020

Uncommon Opportunity: While Others Seek "Shiny Objects" History Suggests You Buy Staples

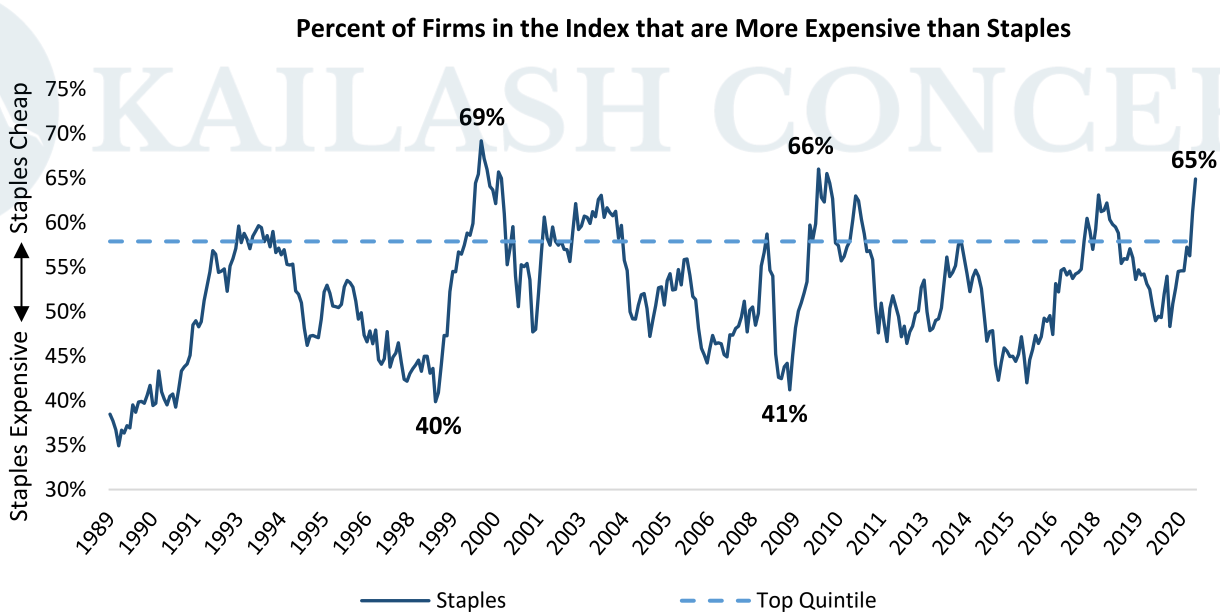
One of the tragedies of markets is that investors repeat the same mistakes again and again. Research from a variety of firms, including Blackrock, Dalbar, and others, confirm that emotions and performance chasing effectively revoke the power of compounding. In this article from MarketWatch they explain that Dalbar's recent study showed investors averaged a 3.7% annual return over a 30-year period in which the S&P 500 averaged 11.1% returns annually.

In the Third Edition of "*What Works On Wall Street*," published in 2005, O'Shaughnessy discusses the dire consequences of performance chasing in periods like today. In reference to the dot.com bubble he wrote:

*The more insanely overvalued a company, the more it soared. Everyone talked of "the New Economy" and how it **really** was different this time … just as the last sane investors capitulated and learned to love the stocks with the craziest valuations, along came the reckoning – all gravity-defying stocks came crashing back to Earth. Fortunes were lost … years after this book was first published [in 1997] – showing decade upon decade of the results of all the various types of strategies – people were more than willing to throw it all out the window because of short-term events.*[4]

The good news for the level-headed and calm investor can be seen in Fig. 9 below. For those who seek stable, profitable, income-generating firms with meaningful barriers to entry like Staples, the historical earnings yield is evidence of an uncommon event. Staples are currently cheaper than 65% of companies in the Index – a level only seen three times before in history.

Fig. 9: Staples are Currently Cheaper than 65% of the Firms in the Index, Near All-Time Record



Source: Kailash Capital; Data from 4/30/1989-12/31/2020

The dashed line in the chart above is the cutoff for periods when Staples were in the 20% cheapest periods of all observations relative to the market.

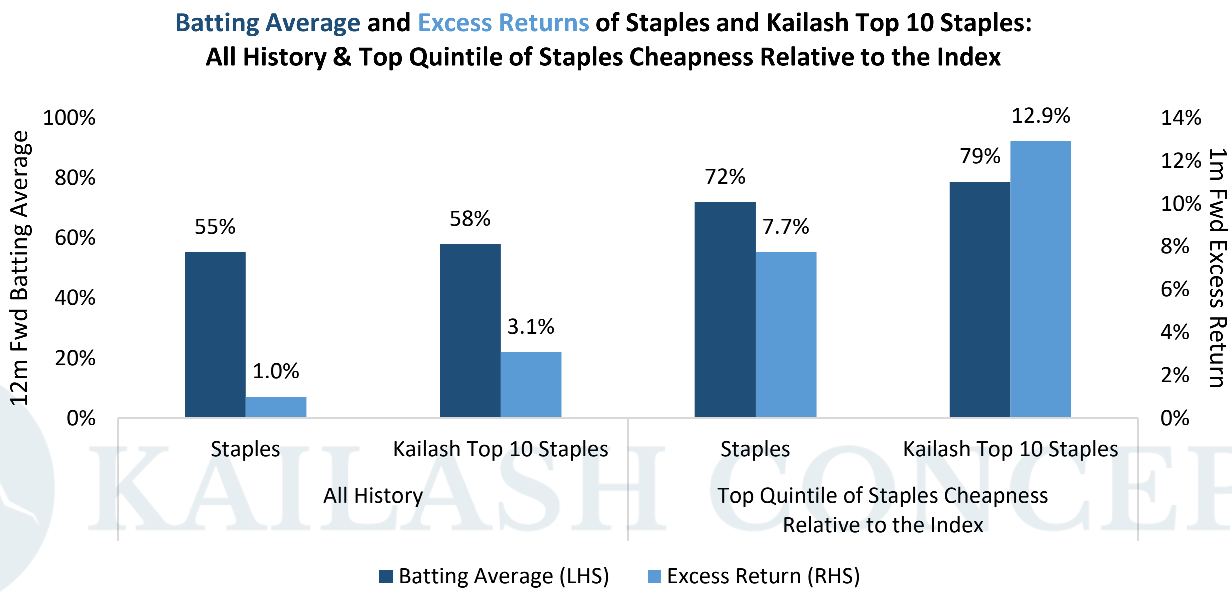
[4] *What Works on Wall Street, James P. O'Shaughnessy, Third Edition, page 377 - 378*

Uncommon Opportunity: While Others Seek "Shiny Objects" History Suggests You Buy Staples

As seen in Fig. 9 above, Large Cap Staples are currently cheaper than 65% of our S&P500 universe. Figure 10 provides the 12-month forward batting average and excess returns of Staples and Kailash's Top 10 Ranked Staples. Looking at the first two bars over "All History," Staples as a whole has outperformed in 55% of rolling 12-month periods by an average of 1%. Looking at the next two bars, consistently buying Kailash's Top 10 Ranked Staples improves the batting average to 58% and provides 3x the average return.

The bars on the right show the performance of Staples and Kailash's Top 10 Ranked Staples in periods like today when Staples are in the cheapest quintile relative to the Index. The payoffs, both in terms of batting average and excess returns, are meaningfully improved for both Staples and the Kailash Top 10 when purchased at steep discounts relative to their own history vs. the Index.

Fig. 10: Staples & Kailash Top 10 Staples Over All of History and Periods Like Today



Source: Kailash Capital; Data from 4/30/1989-12/31/2020

Conclusions:

In closing, Kailash would like to share some prescient and final advice from James O'Shaughnessy's 2005 edition of "*What Works on Wall Street*." Having been recently vindicated from the attacks he suffered in the press at the peak of the dot.com bubble, Jim was wise enough to write the following:

At some other time in the future, any of the strategies in this book will underperform the market, and it is only those investors who can keep their focus on the very long-term results who will be able to stick with them and reap the rewards of a long-term commitment. Nevertheless, you should always guard against letting what the market is doing today influence the long-term investment decisions you make.[5]

Kailash believes O'Shaughnessy's advice then is a critical reminder to investors of all stripes today. This time is not different. The loss-making stocks, the firms at impossible multiples of revenues, rampant investor speculation, and stories of quick riches will end badly as periods like today always have. Kailash recommends investors avoid the hype and enjoy an unusual opportunity to buy some of the market's most durable and profitable franchises at unusual discounts.

Figure 11 below shows the fundamentals of our S&P500 universe, Staples, and Kailash's Top 10 Ranked Staples. While we believe the data speaks for itself, we would highlight the following:

- Looking at P/S, EV/Sales, P/E, and FCF/EV, Staples and the Top 10 Ranked Kailash Staples trade at enormous discounts to the broad universe
- Kailash's Top 10 Staples offer 3.2% cash yields, fully funded by Free-Cash-Flows in an environment where fixed income offers negligible yields and, in the case of high-yield, record low coupons, and weak covenants
- Looking at the last two columns, both Staples and the Kailash Top 10 Staples provide much higher ROEs and ROAs compared to the broad universe

History suggests that there have been few better opportunities to buy some of the market's highest quality stocks at significant discounts. Please see Exhibit 1 on the following page with our ranking of Consumer Staple stocks. Our Top 10 are highlighted in bold.

Fig. 11: Despite Advantaged Fundamentals Staples Trade at a Significant Discount to the Index Today

	P/S	EV/Sales	P/E	FCF/EV	Dividend Yield	SH Yield	ROE	ROA
S&P500 Universe	3.0x	3.4x	38.8x	2.9%	1.4%	2.5%	33.2%	7.3%
S&P500 Staples	1.3x	1.7x	24.8x	3.6%	2.4%	3.2%	50.1%	7.8%
Kailash Top 10 Staples	1.0x	1.2x	20.6x	5.6%	3.2%	4.2%	84.8%	8.1%

Source: Kailash Capital; Data from 4/30/1989-12/31/2020; FCF/EV is ex-financials for S&P500 Universe

[5] *What Works on Wall Street, James P. O'Shaughnessy, Third Edition, page 380*

Exhibit:

Exhibit 1: S&P500 Staples Firms – Kailash Top 10 Ranked in Bold

Aggregate Rank	Ticker	Company Name	Aggregate Rank	Ticker	Company Name
11	**KR**	**KROGER CO**	244	CPB	CAMPBELL SOUP CO
82	**MO**	**ALTRIA GROUP INC**	282	TAP	MOLSON COORS BEVERAGE CO
134	**LW**	**LAMB WESTON HOLDINGS INC**	284	ADM	ARCHER-DANIELS-MIDLAND CO
137	**TSN**	**TYSON FOODS INC -CL A**	310	CAG	CONAGRA BRANDS INC
147	**K**	**KELLOGG CO**	312	BG	BUNGE LTD
150	**SYY**	**SYSCO CORP**	314	EL	LAUDER (ESTEE) COS INC -CL A
157	**PG**	**PROCTER & GAMBLE CO**	327	SJM	SMUCKER (JM) CO
166	**COST**	**COSTCO WHOLESALE CORP**	338	SAM	BOSTON BEER INC -CL A
173	**PM**	**PHILIP MORRIS INTERNATIONAL**	565	DAR	DARLING INGREDIENTS INC
178	**KMB**	**KIMBERLY-CLARK CORP**	357	WBA	WALGREENS BOOTS ALLIANCE INC
182	PEP	PEPSICO INC	372	MNST	MONSTER BEVERAGE CORP
184	HSY	HERSHEY CO	399	BF.B	BROWN FORMAN CORP
195	GIS	GENERAL MILLS INC	430	MDLZ	MONDELEZ INTERNATIONAL INC
198	CLX	CLOROX CO/DE	439	MKC	MCCORMICK & CO INC
209	CCEP	COCA-COLA EUROPEAN PARTNERS	448	HRL	HORMEL FOODS CORP
222	WMT	WALMART INC	452	CHD	CHURCH & DWIGHT INC
224	KO	COCA-COLA CO	464	STZ	CONSTELLATION BRANDS
232	KHC	KRAFT HEINZ CO	514	KDP	KEURIG DR PEPPER INC
239	CL	COLGATE-PALMOLIVE CO			

Source: Kailash Capital; Data from 12/31/2020

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