A TALE OF TWO LUXURIES

"IT WAS THE BEST OF TIMES, IT WAS THE WORST OF TIMES, IT WAS THE AGE OF WISDOM, IT WAS THE AGE OF FOOLISHNESS, IT WAS THE EPOCH OF BELIEF, IT WAS THE EPOCH OF INCREDULITY, IT WAS THE SEASON OF LIGHT, IT WAS THE SEASON OF DARKNESS, IT WAS THE SPRING OF HOPE, IT WAS THE WINTER OF DESPAIR."

-CHARLES DICKENS, A TALE OF TWO CITIES

IT might seem strange to quote the opening lines of Charles Dickens' A Tale of Two Cities to talk about luxury companies today, but the quote is incredibly appropriate. The luxury sector is, at least in theory, a treasure trove of good investments. After all, in which other sector can you raise prices every year with no complaints from your customers? In fact, some customers might not buy some luxury items if the price is not high enough. This is the famous Veblen good effect: as prices rise, demand also rises, which runs contrary to all classical economic theory.

But, even in this sector, one has to be extremely careful today, and be picky about where to invest in. Spoiler alert: just as with luxury goods, you should not buy the cheapest stocks available, but rather the priciest.

We will focus today on six companies: Hermès, Ferrari (technically a carmaker but actually a maker of luxury goods), Richemont (Cartier, Van Cleef & Arpels), LVMH (Louis Vuitton, Moët & Chandon, Loro Piana, Sephora, among others), The Swatch Group (Breguet, Omega, Longines) and Kering (Gucci, Saint Laurent, Bottega Veneta). All six are juggernauts of the sector, with brands that are extremely hard to replicate.

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And yet, they have fared very differently over the past five years, which is due to a combination of managerial decisions and each brand's strengths and weaknesses. Let's take a look at their returns:

As you can see, the two clear winners are Hermès and Ferrari, with Richemont and LVMH in the middle and The Swatch Group and Kering clear underperformers. Unsurprisingly, the two clear winners were the only two about which we didn't need to mention any brands: their brand is in the name and the name is enough, which is already a competitive advantage.

We have only invested in these two companies on behalf of our clients for the past 18 months. There are two main reasons for this. The first one is that there are only four brands that make some products that are actually worth more once you buy them than their sticker price (i.e., you can resell them used at a higher price than new) and these are Rolex, Patek Philippe (both based in Geneva), Hermès and Ferrari.

Rolex is owned by a non-profit foundation and Patek is owned by the Stern family. This leaves just Hermès and Ferrari that are listed on the French and Italian stock markets. Because of this, Bernard Arnault, LVMH's main and controlling shareholder, tried unsuccessfully to buy Hermès a few years ago.

This is as powerful a marketing tool as you can find in the world, and one which is irreplicable. We could give you 500 billion euros and you could not replicate it with a new brand. It is due to a combination of history, brand appeal, actual trends and the tendency of rich people to flock to the same brands, which has only been reinforced by today's social media (Instagram and Tik Tok in particular).

The second reason is China. If you have read our past articles, you know we are very downbeat on China's economic future (the TLDR on this: there has been a huge housing crash, it's done for the next twenty years). China has been the main focus of these companies over the past twenty years and growth there had been incredibly strong until recently. But now it's over and growth has turned mostly negative.

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The main issue is that most of these companies (with Ferrari being the exception) had invested massively in China, opening expensive stores everywhere and expanding their footprints, because they extrapolated past growth into the future. They have now realized that the China show is over and that the expanding middle class have other things to worry about than exhibiting their new wealth via flashy luxury goods.

We have seen this happen before, in Japan after the bubble burst in 1989, which gives us a pretty good idea of what will happen next: the middle class gets wiped out, but the rich mostly stay rich (having had the possibility and the wisdom to invest elsewhere). And the rich buy real luxury goods (Hermès bags and Ferrari sports cars) and not aspirational luxury goods (Louis Vuitton and Gucci bags). Which is why Hermès is the only company still growing in China. In fact, Japan remained Hermès' second biggest market until 2005, in spite of the country's travails.

There is no particular reason to invest in anything else than Hermès and Ferrari, although they are the most expensive stocks of the list. Much like their products, they are probably always too expensive.

And, yes, Richemont and LVMH should be fine, because Cartier and Louis Vuitton remain powerful brands, but their stock market performance will probably remain about half of their better competitors.

And, yes, Kering is incredibly cheap, but the issue is that earnings are actually shrinking, meaning it could actually become more expensive as time goes by.

Which is why you can't buy these companies based on valuation only, especially because, the China experiment having failed, they will have to shrink their presence there, close stores, fire people and try to find new markets (India seems to be the next target, but this will take time and money). Reorganizing on such a scale costs a lot of time and a lot of money, which will also weigh on future earnings.

In this context, it feels like a much better bet to invest in Hermès and Ferrari, which are also rethinking their strategies but which can use their growing earnings to do so and should not suffer much as a result. In other works, stick with the best and forget the rest.

Range 10/28/2019 - 10/28/2024 Period Daily No. of Period 1827 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	RMS FP Equity	EUR	227.18%	239.18%	10.63%	27.63%
2)	RACE IM Equity	EUR	217.97%	228.55%	--	26.83%
3)	CFR SW Equity	CHF	67.10%	88.51%	-140.04%	13.50%
4)	MC FP Equity	EUR	65.19%	77.22%	-151.33%	12.11%
5)	UHR SW Equity	CHF	-32.86%	-24.39%	-252.94%	-5.43%
6)	KER FP Equity	EUR	-52.92%	-47.13%	-275.68%	-11.96%