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Consumer Staples.... Emerging Market Participation with Recession Protection

There are few things more attractive in investing than finding companies priced reasonably that stand to benefit from major potential catalysts. In our opinion, this is the equivalent of getting a ‘call option’ for free. These opportunities are typically difficult to find, because while catalysts are not rare, stocks that have not incorporated a ‘catalyst-premium’ in their valuations are. Today, we believe companies in the consumer staple group stand at the intersection of two potential catalysts that if realized should represent significant upside to their current valuations.

1. **Call Option on a Recession:** Staple stocks have historically outperformed the market during recessions because consumers will continue to eat, clean their homes and groom themselves in all economic environments. Historically, the degree of their outperformance during such periods of economic weakness has been significant. After a five-year bear market, the valuations of staple stocks are in-line with their 20-year historical averages. The ability to purchase staple stocks at average valuations with the prospect for a recession imminent is surprising. It would be analogous to an insurance company writing policies on beachfront property at normal rates as a hurricane brews offshore.
2. **Call Option on the Strength of the Developing World:** Much has been written about the maturing of the developing world and the insatiable demand its populations are likely to create. While commodity prices for energy, food, and metals have been rising in response and anticipation of this demand, the prices of the branded consumer staple companies with significant emerging markets presences have not. We believe it is only a matter of time before the valuations of staple companies appreciate to more accurately reflect the significant opportunities in these markets. One of the first aspirations for many in the developing world, is to purchase the same branded consumer staple products ubiquitous in the developed world. Because of their affordability and luxury allure, personal care products, carbonated beverages, candy and cigarettes are often the first items on the shopping lists of consumers in developing economies as they mature.

Chart 1 shows the price performance (top panel) and valuation (bottom panel) of the S&P Consumer Staple group relative to the equally-weighted S&P 500. During and in the years preceding the last two recessions, staple stocks outperformed the broad market by 30 -60%. Since mid-2007 when the rally began in consumer staple stocks, the group has only slightly outperformed the broader market suggesting additional upside may exist. We shaded the recessions of '90-91 and '00-'01 to aid in the comparison.

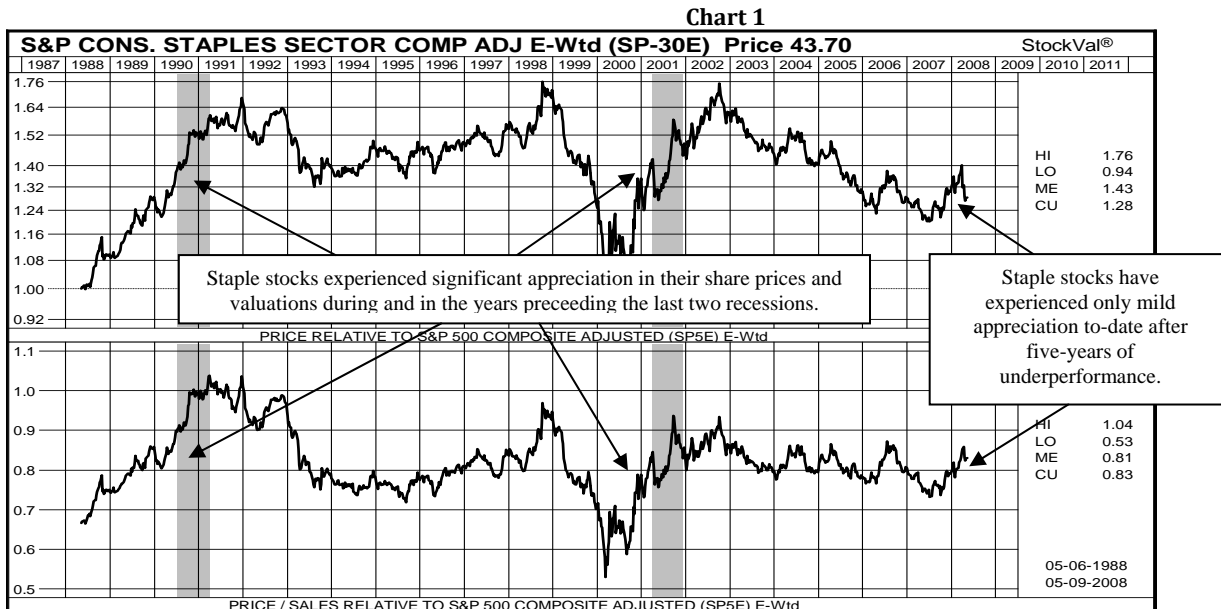


Chart Courtesy StockVal

Bottom Line: We believe the staple stocks will benefit from the three ‘W’s’: Worry, World and Warren. When it comes to ‘worry’, staple stocks have historically offered predictable growth that is valued more highly during difficult economic times. From a ‘world’ perspective, the products and services offered by the companies in this category meet the most basic needs of individuals and should benefit as the developing world comes on-line. The final ‘W’ references Warren Buffet and his financial involvement in the Mars Corporations’ recent offer to purchase one of the industry’s bellweathers: Wm.Wrigley Company (WY-N-\$76.55). Investing in the sector that is drawing the attention of one of the most-revered investment minds of our day, gives us greater confidence that we are on the right track with our outlook. We currently recommend a 200-400 basis point overweight to the staples sector which represents roughly 10% of the S&P 500. For the average investor this equates to holding 2 to 3 positions within a 20-25 stock portfolio.

A few of our favorite staple stocks include: CVS (CVS-N-\$41.34), Church & Dwight (CHD-N-\$53.74), H.J. Heinz (HNZ-N-\$47.73), Proctor & Gamble (PG-N-\$65.21), McDonalds (MCD-N-\$59.24) and Philip Morris International (PM-N-\$51.83). For those looking to implement a consumer staple position via ETF we would recommend the Vanguard Consumer Staple ETF (VDC-A-\$68.32)

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