KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

Investment Theme – Global Consumer
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Considerable time has been spent by the media discussing the overstretched U.S. consumers and their inability to lead the world out of the current slowdown with higher spending. We agree the U.S. consumer has overspent during the past decade in the midst of ever rising home prices and general excessiveness. To achieve better balance in the world economy governments in the developing world realize they will need to encourage the development of their own consumer economies. We believe exposure to this budding middle class will be an important investment theme over the next decade. We also feel the safest and best way to exploit the opportunities within these developing countries is through large, multinational companies with strong global brands. An added benefit of this exposure is the creation of a natural currency hedge within portfolios that will protect against a weakening dollar.

The World Bank estimates that the population of middle class consumers will expand by over 800 million people between 2000 and 2030. In addition, developing countries will account for 93% of the global middle class population in 2030, up from 56% in 2000. Of these additional 800 million consumers, half will live in either China or India.

Although significant progress has already been made during the past twenty years in the developing world, there is still a long way to go. As an example, consumer spending represents 70% of the U.S. economy while in China consumer spending represents only about 30% of their economy. One benefit from the recent global recession was the realization by many export-heavy countries that developing a strong domestic consumer is in their best interest. Consumer based economies are far more stable than export based economies due to greater diversification and a higher complement of consistent service jobs rather than cyclical manufacturing jobs. Even Germany, the most export-heavy developed country, has made statements to the effect they must reduce their reliance on exports in order to have a more stable economy for the next recession. As it stands today, research by JP Morgan shows that, excluding health care expenditures, total emerging market household consumption is now equal to total U.S. consumption. During our last recession in 2001-2003, emerging market household consumption was half of the U.S.

Many investors are led to believe that the best way to gain exposure to this rapidly expanding class of consumers is to invest directly into the stock markets of these emerging economies. These economies have high growth rates which investors assume will lead to higher stock prices. However, a recent study based on decades of data from 53 countries found that the economies with the highest growth have produced the lowest stock returns – by a significant margin. Stocks in countries with the highest economic growth have earned an average annual return of 6%. Stocks in the slowest-growing nations have gained an average of 12% annually. This disparity is due to a number of reasons. Most importantly, the high price investors are paying for this growth. As an example, China's stock market currently trades at 35 times earnings. Meanwhile, the U.S. market is far cheaper with an earnings multiple of only 18.

Even with this valuation disparity, many investors would feel this gap is warranted due to higher growth prospects. These investors are making the error of overlooking the difference between sales growth and profit growth, much like many investors did during the technology bubble in the late 1990s. Competition is fierce in these developing countries as new companies attempt to grab market share. Profitability is often the 2nd or 3rd priority in such instances. As an

777 EAST ATLANTIC AVENUE, SUITE 303 • DELRAY BEACH, FLORIDA 33483 • (561) 278-7862 • FAX (561) 265-1055

example, automobile sales in China are up roughly 50% over last year due to government policies promoting car ownership. Unfortunately, industry wide profitability has actually declined. What typically happens is that companies based in high growth countries will disappoint unreasonably high expectations. Meanwhile, companies in mature markets with lower expectations can usually positively surprise investors with their ability to maximize profitability with only moderate revenue growth.

For these reasons, we believe the best way to exploit this emerging global consumer trend is through the ownership of large, multinational companies with strong brands and proven track records. Many of the multinational companies we own have at least 50% of their sales outside the U.S. with 15-20% of their sales in these developing markets. As an example, Procter & Gamble derives 32% of their sales from developing markets while generating a total of 60% outside the U.S. In addition, BusinessWeek recently released their annual survey of the most valuable global brands and P&G owned two (Gillette #13; Duracell #85). The chart below shows the figures for several other top holdings as well as their global brand ranking as evaluated by BusinessWeek:

Company	**U.S. revenue**	**International**	**Brand rank**
Philip Morris International	0%	100%	17*
Nokia	4%	96%	5
Coca-Cola	20%	80%	1
Avon	24%	76%	67
IBM	35%	65%	2
General Electric	47%	53%	4
Johnson & Johnson	50%	50%	80
Kimberly-Clark	50%	50%	71**
Pepsi	52%	48%	23

*Marlboro
**Kleenex

Ideally, client portfolios have holdings that derive approximately 40-50% of their revenues from international markets. This produces diversification through exposure to many different economic opportunities around the world as well as a natural hedge against currency movements (the weakening dollar). Over the past year, we have paid considerable attention to this rapidly emerging trend and the majority of our managed portfolios already reflect this positioning. Going forward, we continue to track companies that fit the profile of high-quality, multinational businesses with strong global brands. We believe these companies offer the best return for the amount of risk involved.

Truly yours,

Keating Investment Counselors, Inc.