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INVESTMENT MANAGEMENT

AN IN-DEPTH ANALYSIS

- ◆ WHAT DRIVES CONSUMER BEHAVIOR?
- ◆ HOW HAS THE CONSUMER FARED DURING THE LAST FOUR RECESSIONS?
- ◆ HOW DOES THE CURRENT ENVIRONMENT COMPARE?
- ◆ HOW DOES ONE INVEST IN THE CONSUMER SECTOR IN THIS ENVIRONMENT?

TAPPED OUT?

STATE OF THE U.S. CONSUMER

November 2008



CER • E • BRATE

To use the mind: think

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EXECUTIVE SUMMARY

The effects of the Credit Crunch have come to roost at the next level—the consumer. This paper examines what drives consumer behavior, how the consumer has fared during the last four recessions, how the current environment compares to these previous downturns, and how one can successfully invest in the consumer sector during these tumultuous times.

WHAT DRIVES CONSUMER BEHAVIOR?

Perceptions are the main influence that drive the actual action of spending throughout various life cycles: Child/teen, young single, young couple, full nest, empty nest, and widow(er). These perceptions are primarily driven by the wealth effect and consumer confidence. Housing and stock prices impact the wealth effect while consumer confidence is driven by expectations for energy prices, housing turnover and pricing, labor and wage growth, and the Federal Reserve's outlook. Both the wealth effect and consumer confidence have been eroded by the downturns in the housing, credit, and stock markets and by rising fuel, food, and commodity prices. Consumer debt, a key factor in the steady growth of consumer spending over the years, has risen to record levels with the U.S. ranking last in savings versus other industrialized nations. These negative forces have led the economy into the recession that many believe we are now experiencing.

THE CONSUMER IN PREVIOUS RECESSIONS

The last four U.S. recessions, the 1973 Oil Crisis, the Reagan Recession, the 1991 Recession, and the 2001 Recession have all been driven by some similar and different factors to today's situation. In the 1973 Oil Crisis, oil prices quadrupled and led to the first fuel shortage since World War II. Although consumption was buoyant, there was a steep decline in personal savings and consumer confidence hit a low of 43.2, a level not reached again until March of 2008. The Reagan Recession was marked by the first election year in history in which consumer spending fell, interest rates were at 20.0%, and unemployment was higher than at any time in the post-war era. The 1991 recession was highlighted by the Savings & Loan crisis and a debt-ridden consumer facing declining home values. The 2001 recession was marked by a significant drop in business expenditures after Y2K and the events of 9/11. However, the recovery after 9/11 was swift, based on tax incentives and aggressive Fed action.

HOW DOES THE CURRENT ENVIRONMENT COMPARE?

We are now at a point in time where we have a “perfect storm” on our hands. The current era is marked by a severe housing collapse, with some forecasts predicting prices weakening through at least mid-2009; consumer debt at all-time highs and a Fed caught between a rock and a hard place trying to balance inflation risk with an already low interest-rate environment and low consumer confidence; rising food costs based upon rising global demand from emerging economies and the U.S. now needing to vie for commodities; rising private sector unemployment; baby boomers heading into retirement, a major driver of consumer spending over the years; and a weak U.S. dollar escalating the prices of foreign goods in the U.S. Further, we are experiencing a crisis not seen in decades as the above mentioned factors have collapsed a financial “house of cards” that has led to the demise of once heralded firms, such as Lehman Brothers and Bear Stearns, and a shattered sense of confidence in the American financial system.

HOW DOES ONE INVEST IN THE CONSUMER SECTOR IN THIS ENVIRONMENT?

While each of these factors is daunting, we believe in reversion to the mean. Although the duration of the housing and financial crisis is unclear, once we see a return of stability in these markets, a rise in consumer confidence should follow. Consumer stocks usually lead after a weak market. However, given the events in 2008 to date, the recovery could be more muted and prolonged than in past eras. Since nobody knows when this recovery will occur, we believe that a consistent, high-quality investment philosophy is the most effective approach to the market over the long-term.

Kayne Anderson Rudnick focuses on what we believe are high-quality companies, those that can prosper in good times and bad. In the consumer sector, we focus on companies that are not subject to the whims of customers with fleeting tastes, instead we look for companies that provide a true value-added aspect to the industry, whether or not the consumer is spending. We focus on companies that have sustainable competitive advantages that can be maintained in good and poor economic times through strong brands, niche markets, solid management teams, and resilient balance sheets. We believe that over the long-run, and especially during these turbulent times, our philosophy is well positioned.

HEADLINES

Tighter Lending Standards Likely to Restrain Consumer Activity

Consumers Could Lead Economy Into the Abyss

Consumer Confidence at Lowest Level in Over 20 Years

Home Foreclosures Rise at Fastest Rate in Three Decades

New Home Sales Fall to Low Last Seen in 1990s

U.S. Unemployment Levels Hitting Recession Territory

A look at the headlines over the past year could force the average person to pack their bags and head for Siberia (too bad all the airlines have stopped flying there due to skyrocketing fuel costs). Even if you could get there, who's going to lend you the money to buy an igloo?

In our first White Paper titled *Credit Crunch*, we discussed the repercussions of the subprime mortgage meltdown on the U.S. economy. The effects of this meltdown have now come to roost at the next level—the consumer.

Unlike other economic sectors, the consumer sector is the one most relatable to everyone. We are all consumers. We get up everyday and consume something: Gasoline; Big Macs; books; video games; Q-tips; grande, extra hot, non-fat, no foam latte with whip cream (no lid please). The consumer is the single driving force that, as a whole, can determine if an economy is healthy or weak. Consumers have mitigated the impact of the last two recessions in the U.S. The question is: Are things different this time? How do our spending habits impact the global market? Are we at a perfect storm in terms of domestic political and financial issues that, combined with geopolitical volatility, may plunge us into what many believe could be a new world order for our economy?

This paper will examine the essentials of what drives consumer behavior. We will also look at how the consumer fared during the last four recessions and how the current environment compares to previous economic downturns. Finally, we will examine where we go from here, including how we believe one can successfully invest in the consumer sector during this tumultuous time.

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WHAT IMPACTS THE SPENDING BEHAVIOR OF THE AVERAGE CONSUMER?

What drives consumer behavior? Why do we pay that extra \$1000 for the 62" plasma television rather than "suffer" with the 50"? What are we feeling when we upgrade our standard hotel room on Kauai to an ocean view? Are we addicted? Can we not say no? Maybe, but more practically, it is our perception that we can afford these things that drives our decisions. Of course, any study dealing with "averages" needs to caveat the discussion that responses vary with different groups of people from various socio-economic backgrounds with rampant cultural variations. For the purpose of clarity and efficiency in this discussion, we shall discuss in generalities.

LIFE CYCLES AND CONSUMER SPENDING

CHILD/TEEN

- **Focus:** Entertainment items
- **Source of Income:** Parents

Children/teens are driven by social status and peer pressure in their spending habits—driven by their parents' seemingly bottomless wallets.

YOUNG SINGLE

- **Focus:** Brand-centric
- **Source of Income:** New jobs/parents

Young singles tend to spend more on status things (well-branded jeans, shoes, and sunglasses) while skimping on everyday items, such as furniture and food (IKEA and Target).

YOUNG COUPLE

- **Focus:** Practical products
- **Source of Income:** Emerging careers

Young couples are focused on building a home, switching from status items to practical ones.

FULL NEST

- **Focus:** Consumption
- **Source of Income:** Peaking career

Full Nest tends to be the greatest consumption stage as incomes tend to be the greatest at this time and family needs grow with that income.

EMPTY NEST

- **Focus:** Inward wants/needs
- **Source of Income:** Career/retirement

Empty Nest can also be a high spending phase as the focus goes from the kids to the parents as they itch their long suffering egos—Harley-Davidson anyone?

WIDOW(ER)

- **Focus:** Health/legacy spending
- **Source of Income:** Retirement account

Widow(er) tends to be a slower spending phase as seniors focus on savings as income falls and other issues, such as health, take precedence.

Perceptions are the main influence that drives the actual action of spending throughout these cycles. When we believe we can afford something, we tend to buy it. But what drives these perceptions?

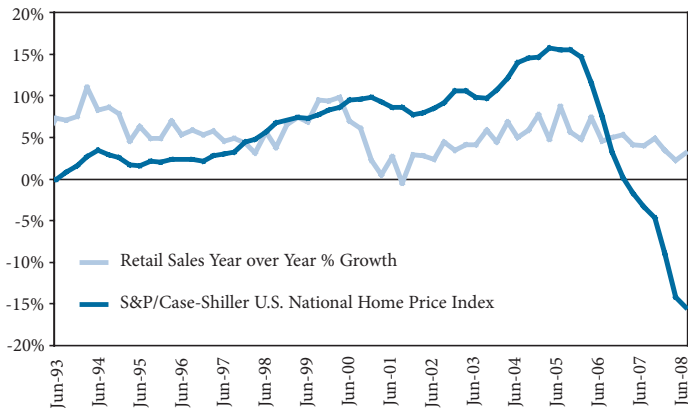
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THE WEALTH EFFECT

The wealth effect is an economic term that refers to an increase in spending that accompanies an increase in wealth (in absolute terms) or merely a perceived increase in wealth (in relative terms). Economists believe people spend more when one of two things is true: People actually are richer (by objective measurement, for example, a bonus or a pay raise at work, which would be an income effect), or people perceive themselves to be “richer” (for example, the assessed value of their home increases or a stock they own has gone up in price).

Housing has had a significant impact on creating a large wealth effect in the U.S. This is further driven by the availability of home equity lines due to rising home values. As evidenced by the chart, *Consumer Spending vs. Housing Market*, and in our later discussion of past recessions, home values and consumer spending tend to be highly correlated.

CONSUMER SPENDING VS. HOUSING MARKET



Source: Standard & Poor's and Bloomberg

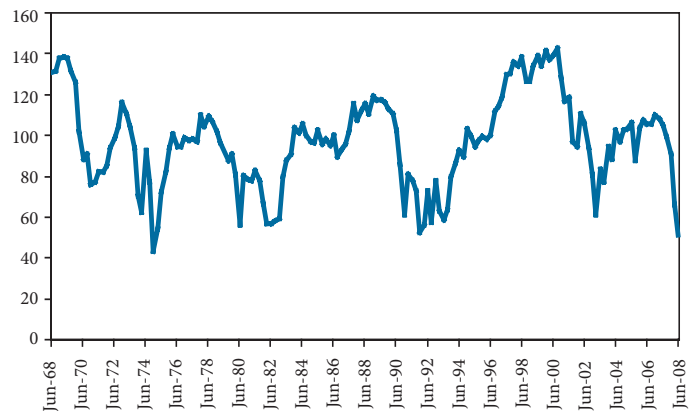
Stock prices also impact the wealth effect—many times with equal magnitude as housing. Consumers spend about 5 ½ cents for every dollar of appreciation in housing or stock wealth in the long run. The difference between the two is the timing—housing may be more immediate to the economy as the price volatility in housing tends to be lower than the stock market. Most view housing as a less risky investment than stocks—of course, even this has been called into question after the subprime meltdown of 2007.

The wealth effect has triggered almost 20 years of strong consumer spending. But there are other factors, outside of the wealth effect and one's employment status, that impact spending as well.

CONSUMER CONFIDENCE

One of the main drivers of spending is consumer confidence. Consumer confidence is the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending. Factors that affect this index are expectations for energy prices, housing turnover and home pricing, labor and wage growth, and the Federal Reserve's outlook.

CONSUMER CONFIDENCE



Source: Bloomberg

Consumer confidence has been approaching record lows over the last few months due to a variety of issues facing the consumer today. We all know how oil prices have risen over the past few years. Americans are spending a larger share of their income on energy than at any time since 1986. And we are facing a similar situation with natural gas, steel, and basic food goods. That spending has crimped pocketbooks, dampened consumer sentiment, and reduced purchases of everything from cars to clothing.

\$4 GASOLINE

Now that we have seen the era of \$4 per gallon gasoline, what can we expect to see from the consumer? A survey done by Cars.com in early 2008 said that 85% of consumers would buy a more fuel-efficient car if \$4 per gallon of gas remained for a prolonged period. And 57% said they would buy one the next time they purchased a car. Of course, there is a price to which this becomes prohibitive to many—hence the complex fabric of the human condition and consumer spending. Ultimately, this has the impact of lower sales in new cars overall given the low supply of inexpensive alternative vehicles in the U.S.

UTILITIES

In addition to petroleum-based gasoline, the natural gas that warms your house is being driven higher by global demand from emerging economies, such as China and India. Further, water is becoming scarcer as demand rises from a larger population that

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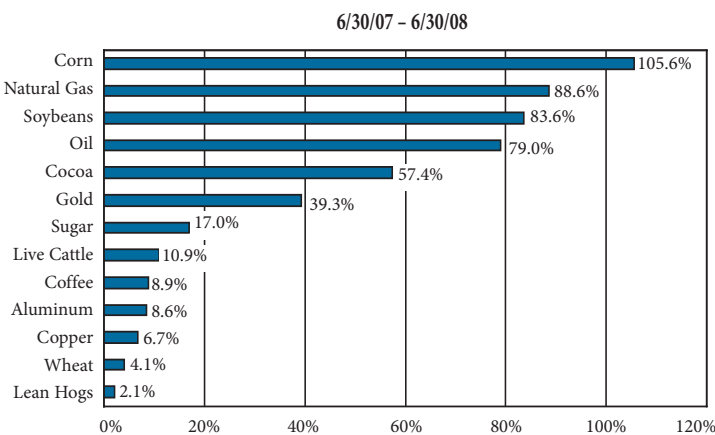
has greater agricultural needs and recreational demands. With utilities rising at historically large rates, the consumer is now spending greater amounts of their disposable income on these necessities, further impeding other discretionary spending.

FOOD AND COMMODITIES

For many years, we have been the beneficiary of emerging economies in that they have provided low-cost alternatives for us to outsource manufacturing, import inexpensive food goods, and increase our overall efficiency in producing a good or a service—one of the reasons we have seen low inflation and sustained increases in corporate margins. However, we have now come to an era where those countries themselves demand the same goods and services that we have enjoyed for many years.

With the ascension of these countries, we are seeing a dramatic increase in global demand for energy and food resources.

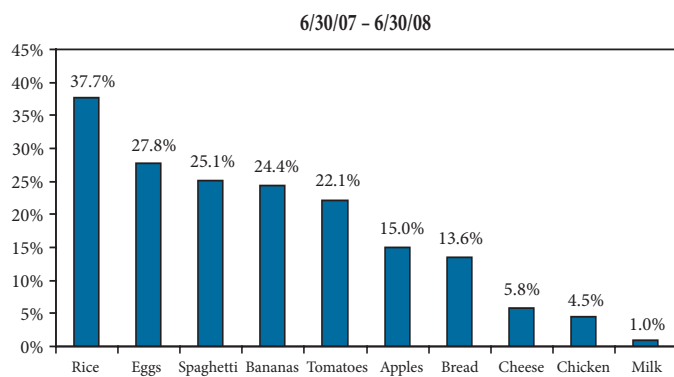
PRICE CHANGE OF COMMODITIES



Source: Bloomberg

This is also true for everyday goods, as we can observe the change in prices in the last year on a grocery bag example of goods.

PRICE INCREASE IN FOOD STAPLES

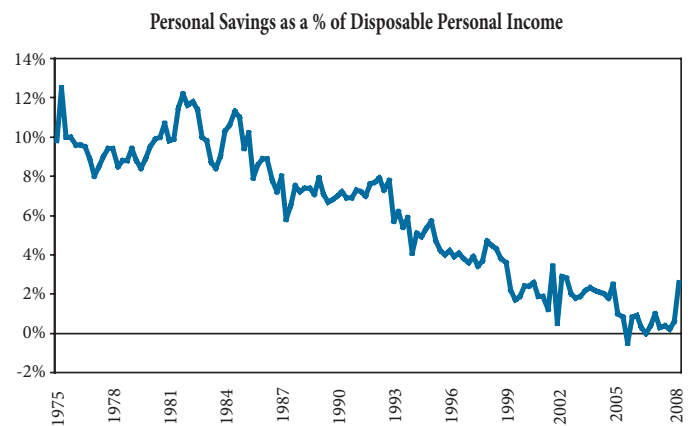


Source: Bureau of Labor Statistics

CONSUMER DEBT

The U.S. is a country of debtors. Many statistics point to Americans' inability to save, plan for retirement, or spend less than what they make. In fact, on average, we spend more money than we make by 20% to 30%. This trend is another key factor in the steady growth of consumer spending over the years. In addition to the wealth effect which has provoked the increased use of home equity lines to spend with reckless abandon, the ease of obtaining credit cards has only exacerbated the problem of personal savings and injected the consumer spending vehicle with more fuel. Given the events so far in 2008, we are beginning the process of what could be a very painful rebalancing and unwinding of consumer debt that should wreak havoc on Gross Domestic Product (GDP)—thus implying recessionary consequences. In order to see sustained and reasonable economic growth again, the bar for consumer debt needs to be reset.

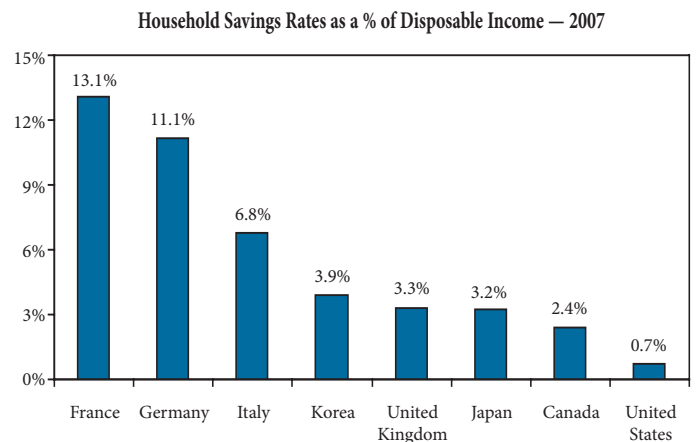
PERSONAL SAVINGS AND INCOME



Source: Bureau of Economic Analysis

While global personal savings rates have been in a steady decline over the past 30 years, the U.S. ranks last in savings versus other industrialized countries.

PERSONAL SAVINGS RATE BY COUNTRY



Source: Organization for Economic Co-operation and Development

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THE CONSUMER IN PREVIOUS RECESSIONS

How has the consumer held up in previous recessions?

While we could draw back in history to the late 1700s to find periods of recession—defined as a decline in the country's GDP for two successive quarters—let's focus on the last four notable economic downturns. What was the government's response and how did the consumer fare in these rough times?

In general, there are several ways the Federal Reserve and the U.S. government have stimulated activity in the U.S. economy. The Fed has lowered interest rates to encourage consumers to take on more debt and re-enter the economy through increased consumer purchases (requires lag time to work its way through the economy). Or the government has enacted an economic stimulus plan with tax cuts or tax-rebate checks to consumers that can be immediately spent on goods and services. These strategies have had varying degrees of success in the last four economic recessions.

1973 OIL CRISIS

STATISTICS	
Consumer Confidence:	43.2
Steep decline in personal savings, buoyant consumption; Consumer Confidence Index would not be this low again until March 2008	
Inflation (YOY % Change):	12.2%
Increase driven by an accommodative Fed, stagnant output, and high spending levels	
Interest Rates:	13.0%
Unemployment:	9.0%

As the Yom Kippur War waged in October 1973 with Egypt and Syria invading Israel, OPEC announced it would no longer ship oil to nations that supported Israel in the conflict. Because of the dependence of the industrialized world on crude oil and the predominant role of OPEC as a global supplier, oil prices increased and were dramatically inflationary to the economies of the targeted countries, subsequently suppressing economic activity.

In 1974, the price of oil tripled to \$12 per barrel and gasoline went from 38.5 cents per gallon in May 1973 to 55 cents in June 1974. With the embargo, the U.S. had its first fuel shortage since World War II. Gas rationing began in 1974 with "odd-even days" that allowed consumers to buy gasoline on odd numbered days of the month if their license plate ended in an odd number and vice versa.

This was an era when the U.S. consumer faced a plethora of dire issues: Inflation, an economic slowdown, the humiliation of Watergate and a weakened presidency, the retreat from the U.S. embassy in Saigon, and international financial chaos.

Despite this, consumer spending was relatively buoyant, leading to a steep decline in the savings rate. Consumers believed that the oil shortages were temporary, and therefore jobs and capital would not be constrained over the long-term. Therefore, households believed that their current income was substantially below what it would be in later years.

The Federal Reserve encouraged the banking system to provide more money than the public was willing to hold, in an apparent attempt to induce more economic growth than was compatible with the reduced supplies of oil, labor, and capital. The result was a rise in the inflation rate.

Eventually, OPEC lifted its oil embargo, thus easing oil prices. But the effects of the energy crisis lingered throughout the rest of the 1970s as higher energy prices were induced by the weaker U.S. dollar in world markets. The consumer and the business community adapted through energy conservation and the production of smaller, more fuel-efficient vehicles. Many argue that the 1973 oil crisis and the accompanying economic slowdown never had a real recovery, with the Iran Hostage Crisis in 1979 leading to the subsequent Reagan Recession of 1981. However, oil's impact on the world became more evident than ever from that day forward.

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THE EARLY 1980s RECESSION (THE REAGAN RECESSION)

STATISTICS	
Consumer Confidence: Consumer recession; 1980 was the first election year in history in which consumer spending fell	56.1
Inflation (YOY % Change): Inflation averaged 3.2% annually in the post-war period	14.6%
Interest Rates: Rates were at 11% in 1979	20.0%
Unemployment: Higher than at any time in post-war era	10.8%

The Federal Reserve's extremely tight monetary policy unintentionally plunged the American economy into a deep recession. Employment conditions deteriorated throughout the year. Unemployment rates for every major group reached post-war highs, with men age 20 and over particularly hard hit. The recession also worsened due to a weakened banking system that was affected by a wave of deregulation. The Savings and Loan crisis was not far ahead.

The Reagan tax cuts helped ebb the economic forces that were plunging the country to the verge of a full-blown depression. The lowering of the personal marginal tax rate combined with ongoing spending in government programs, including defense and lower interest rates, stimulated capital spending and investment. This created a substantial recovery in many of the industries that were hit hardest by the recession, including the airline and auto industries. The consumer also made a strong comeback, with the remainder of the 1980s being labeled the "Me Decade" with the free-spending of consumer demand goods ranging from VCRs to PCs to cable TV.

1991 RECESSION

STATISTICS	
Consumer Confidence: Reluctance to spend; limited credit from Savings & Loan crisis	61.2
Inflation (YOY % Change):	6.4%
Interest Rates: Rates were at 11% in 1979	8.0%
Unemployment:	6.8%

While there is no consensus as to what created the 1991 economic downturn—the first Gulf War; George H.W. Bush's tax increases; the ongoing Savings & Loan crisis—consumer sentiment deteriorated sharply before the leading indicators began to deteriorate in earnest, as if U.S. consumers anticipated a slowdown, due possibly to their realization that their debt levels were not sustainable or, more generally, that economic growth was not sustainable. The limited credit provided by financial institutions produced tight money without a tight monetary policy by the Fed.

There were two significant areas that hobbled the start of a recovery: The public's gloomy outlook and consumers burdened with a heavy debt-load incurred from the 1980s spending spree. Part of the reason for the gloomy outlook can be traced to the drop in home values. Often, this is the largest single asset for an individual and serious declines in value cause a significant drop in net worth. While the perceived change in wealth may be greater than the actual drop, for a public accustomed over the past 10 to 20 years to ever-appreciating home values, any drop comes as a shock, and it forced many to reconsider their financial planning.

The combination of debt and a pessimistic outlook meant there was little incentive to borrow. Cornerstones of past recoveries were construction and auto sales, but new home starts in the early 1990s were at their lowest level since 1946 and auto sales fell to the lowest level since 1982. The Fed's policy of lowering interest rates did not induce consumers to borrow and spend initially as housing was still weak and the first Gulf War drove oil prices higher. But as the Fed became more aggressive in easing and the war came to a relatively quick ending, economic expansion sluggishly returned beginning in 1992.

2001 RECESSION

STATISTICS	
Consumer Confidence: Exemplified the resiliency of the consumer bolstered by previous year's tax cuts and consumer incentives after 9/11	84.9
Inflation (YOY % Change):	3.6%
Interest Rates: Long-term rates declined significantly in advance of the cycle peak; residential fixed investment received a significant boost	1.8%
Unemployment:	5.7%

This recession, like all previous post-World War II recessions, was dominated by a substantial swing in business fixed investment. After little growth during the fourth quarter of 2000 and the first quarter of 2001, business expenditures on capital goods, structures, and equipment and software, fell sharply over the final

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three quarters of 2001. This investment bust, though, came on the heels of the investment boom of the latter half of the 1990s (Y2K).

Housing fared well during this recession because long-term interest rates declined significantly in advance of the cycle peak. In a typical recession, long-term rates rise until the cycle peak, give or take a month or two. As long-term interest rates came down following the spring of 2000, residential fixed investment received a significant boost. While the boost was not sufficient to completely offset weakness in other sectors of the economy, particularly the manufacture of high-tech capital goods and structures, it was important in limiting the severity of the downturn in the aggregate economy.

While this recession was almost unperceivable before 9/11, the terror attacks on the World Trade Center changed all that. After 9/11, all U.S. stock markets were closed for 6 days—reopening on September 17 with the Dow Jones Industrial Average dropping 684 points (7.1%), the largest one-day point decline in history to that point.

However, with the Fed getting aggressive by dropping rates four times in the three months after 9/11 and the government issuing tax-rebate checks, consumer spending saw a dramatic comeback. According to the National Bureau of Economic Research, the recession ended in November 2001—just 50 days after 9/11. Retail sales in October 2001 were higher than in August and real GDP grew at an annualized rate of 1.6% in the fourth quarter.

How did this happen? The previous year's tax cuts likely helped bolster household incomes and spending. Much of the strength was concentrated in consumer durables, which rose at an astounding annual rate of 39.4%. In an average recession, real consumer durables expenditures decline about 3.5%. A key part of the story was new vehicle production, which surged in response to the exceptionally rich sales incentives offered by automotive manufacturers in the aftermath of September 11. These events were obviously unique to this recession.

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WHY IS THIS (NOT) DIFFERENT?

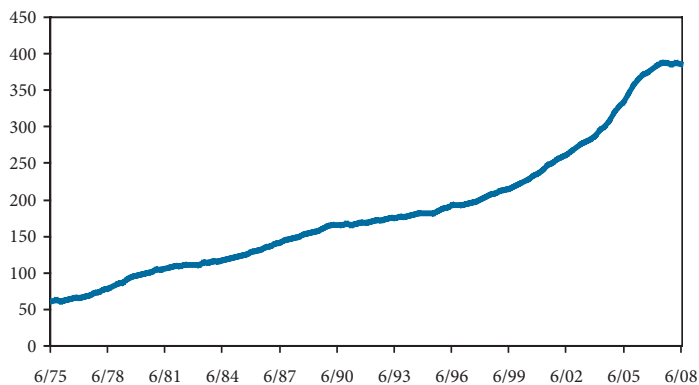
We are now at a point in time where we have an almost “perfect storm” on our hands. Let’s examine today’s issues to see how they are similar or different from past eras of economic hardship.

CURRENT STATISTICS	
Consumer Confidence:	59.8
Inflation (YOY % Change):	5.4%
Interest Rates:	1.8%
Unemployment:	6.1%

HOUSING COLLAPSE

“Real estate never goes down.” So the quip went in the early 2000s as home values skyrocketed. We heard the same thing in the late 1990s as stocks soared to space ship levels and the stock market crash of 1987 was a distant memory for myopic investors. While we have had real estate declines throughout history, buyers again seemingly forgot the cyclical nature of the industry. However, as evidenced by the chart, *Home Prices in the U.S.*, and the peak most believe was reached in 2005, the U.S. was due for a real estate correction.

HOME PRICES IN THE U.S.

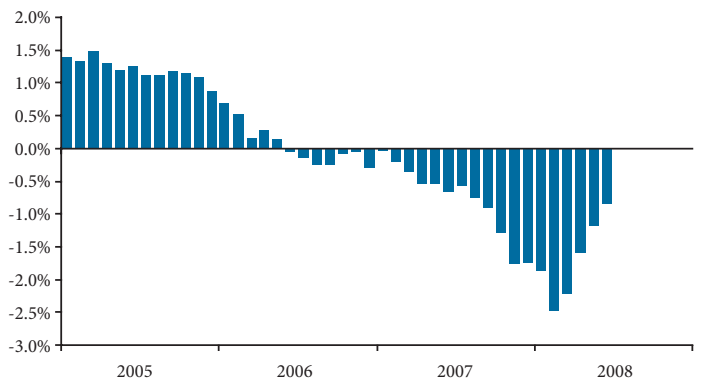


Source: Bloomberg and Office of Federal Housing Enterprise Oversight

Since the summer of 2006, existing home prices have fallen about 8.5% nationwide, with many expecting a similar decrease still to come. Just how low can they go? Forecasts by Moody’s Economy.com now use a 20% drop in median existing home prices from their 2005 peak as a baseline, with prices weakening

through at least mid-2009. The forecast assumes the U.S. is already in a mild recession. This amount would be greater than the decline during the 1990s housing recession. There has been a large increase in foreclosures due to the resetting of adjustable rate mortgages, which has been exacerbated by the credit crunch. With deteriorating home values, consumer spending is affected by a negative wealth effect.

RATE OF DECLINE IN HOME PRICES MODERATING



Source: ISI Group

Still, the worst scenarios could prove no more than a cautionary tale. Home prices remain a largely local phenomenon, with the largest declines coming in parts of the country that watched prices soar the most during the boom. Also, there are rosier forecasts than Moody’s. Lawrence Yun, the chief economist at the National Association of Realtors, says the worst outcome for housing would require a period of stagflation—slow growth and prolonged job losses coupled with rising inflation. Most analysts expect the economy to avoid that 1970s-era threat as inflation cools amid slower growth.

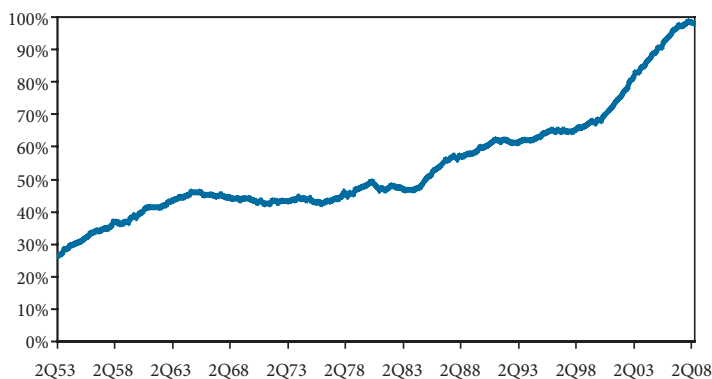
As evidenced throughout history, real estate is cyclical. Eventually, the excess supply of homes is worked through; banks begin loosening up loan underwriting restrictions, prompting new loan activity; and home prices stabilize and, in some regions, begin their ascension again. As home values rise, the wealth effect prompts consumer spending as housing turnover and home-improvement loans create multi-level activity.

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CONSUMER DEBT AT ALL-TIME HIGHS

Consumers were already highly leveraged coming into this credit crunch. Therefore, their ability to take on additional debt may be more limited than earlier in the decade. Further, the savings rate is at near record lows. If job losses accelerate, debt burdens become more challenging to handle and could further impact spending overall.

CONSUMER DEBT VS. GDP



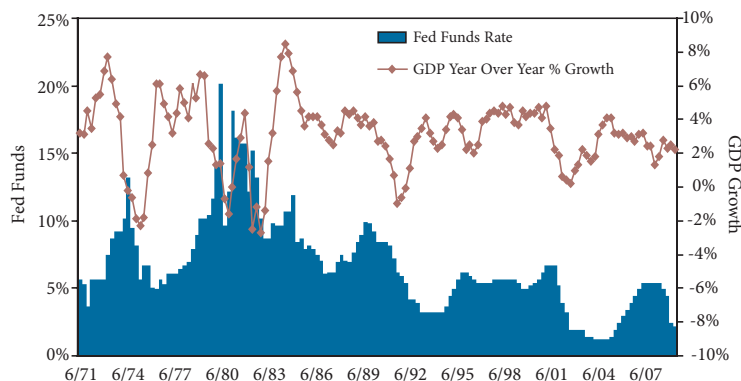
Source: Bloomberg

In past recessions, namely 1991 and 2001, strong consumer spending mitigated these “mild” recessions due to the increase in consumer debt. The debt was being accrued in an environment of falling nominal interest rates. But today, consumers are already debt-heavy going into this economic downturn and the Fed has limited ability to lower rates further given the expected inflation rate.

Historically, the Federal Reserve has acted as both a hero and villain to the U.S. consumer as it pertains to their spending patterns. The Fed is constantly walking a fine line with the

consumer—lowering rates to stimulate spending, but monitoring prices to avoid inflationary times, and increasing rates to avoid an overheated scenario.

GDP AND FED RATES OVER THE PAST 30 YEARS



Source: Bloomberg

We are in an era currently where the Fed may be between a rock and hard place. While interest rates are at historical lows, we are already seeing consumer confidence and spending hitting the lowest levels seen in years thanks to the subprime credit fiasco and housing crisis. Combined with energy and food costs hitting all-time highs, the consumer is in a tough position. Should the Fed decide to combat inflation by raising rates, they are in danger of delaying any hope for a housing recovery and assuring that consumers will continue to wallow in debt with high credit-card rates. We believe the Fed needs to tread carefully here until we have more definitive signs that the economy is indeed in recovery mode. The risk of a lingering consumer downturn could be catastrophic to the economy that could prevent a recovery from occurring for several more years.

RETAIL — A POWERFUL INGREDIENT OF GDP

- Retail sales, at about \$5 trillion, represent 16% of U.S. GDP.
- Retail employs 21% of the U.S. workforce.
- One of the problems facing retail today is that we are overstored in the U.S.
- 7,000 retail stores could close this year, including a large number of bankruptcies.

RETAILERS DECLARING BANKRUPTCY OR LARGE STORE CLOSURES (2007 AND 2008)

- | | | |
|-------------------------|-----------------------|---------------------------|
| • Levitz (BK) | • Wilson Leather | • Harvey Electronics (BK) |
| • Sharper Image (BK) | • Charming Shoppes | • Zales |
| • Linens n’ Things (BK) | • CompUSA (BK) | • Foot Locker |
| • Bombay Company (BK) | • Lillian Vernon (BK) | • Mervyn’s (BK) |
| • Friedman’s | • Fortunoff (BK) | • Wickes Furniture (BK) |
| • Ann Taylor | • Talbot’s Kids/Mens | • Steve & Barry’s (BK) |

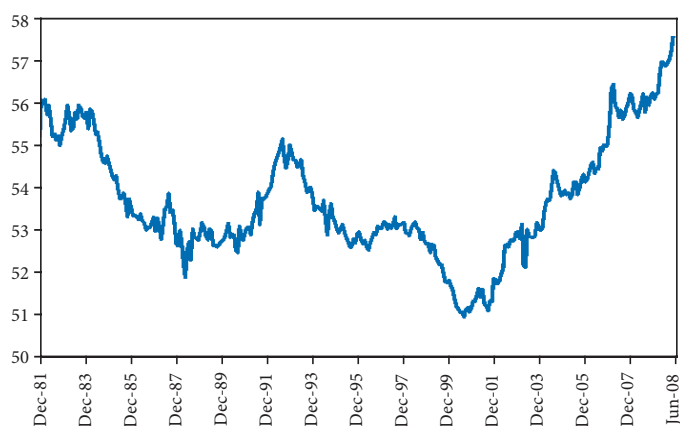
Note: (BK) denotes bankruptcy

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FOOD COSTS RISING DUE TO GLOBAL DEMAND

The ability for consumers to spend on discretionary items, which drives economic growth, is determined by what they spend for basic goods, such as food. U.S. spending on necessities as a percent of total personal consumption expenditures has risen to over 57%. With energy prices near record levels, we have also seen U.S. food prices rise, exhibiting the highest increase in 17 years. Food prices rose 4% in 2007 compared to an average of 2.5% over the past 15 years. This year does not appear to be any better with many projecting an increase of 4.5%. The inflationary pressures on these items have come from several factors, including higher commodity costs for wheat, corn, soybeans, and milk.

U.S. SPENDING ON NECESSITIES AS PERCENT OF PERSONAL CONSUMPTION EXPENDITURE



Source: Bloomberg

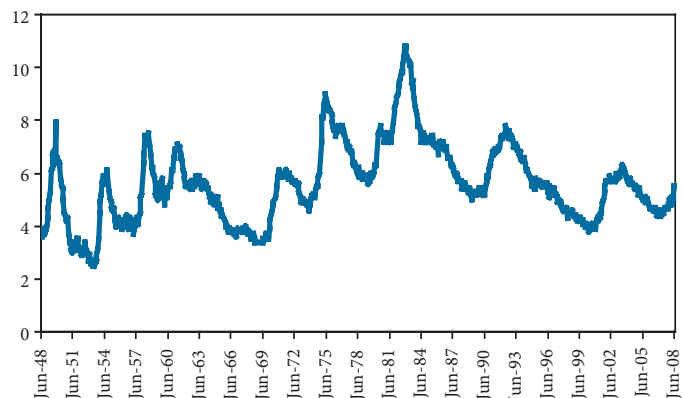
Why have we seen commodities rise? China and India have emerged as new economic powers in the last 10 years. Many are predicting China's economy will be larger than the U.S. economy in about 20 years. Rapid economic growth in China and India has increased demand for meat, corn, and wheat. Due to the weak U.S. dollar, it is cheaper for these countries to import these goods from the U.S. In addition, alternative fuels, such as ethanol, have diverted corn from dinner tables into fuel tanks.

While there was an increase in food prices in 1973, those increases were driven by torrential global weather conditions that created crop failures combined with increasing U.S. demand due to the ongoing recovery from the 1971 recession. However, the increases we are seeing today may be longer lasting with the new paradigm created by the global dynamics. In the past, the U.S. economy was the global driver of demand for goods, therefore, influencing prices that created its own checks and balances as the economy fluctuated. However, with China, India, and other countries emerging as economic powers, the U.S. consumer must now vie for products and commodities that could create inflationary pressures that may not subside for an extended period of time.

UNEMPLOYMENT: PRIVATE VS. GOVERNMENT

"A recession is when your neighbor loses his job, and a depression is when you lose yours." – Harry S. Truman

U.S. UNEMPLOYMENT RATE



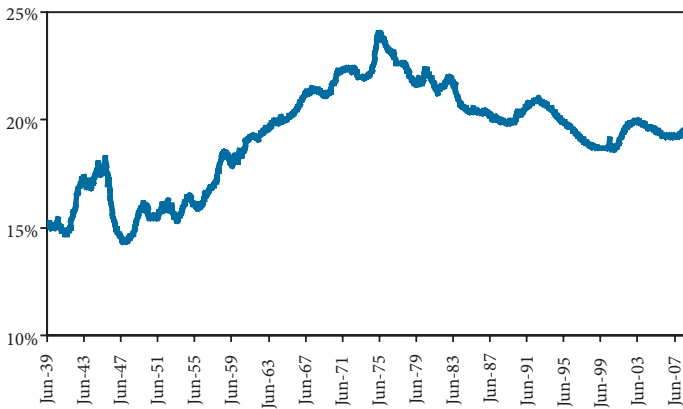
Source: Bloomberg

A key difference in today's economic quandary is that we are not seeing the 9% to 10% unemployment rates of the recessions of the 1970s and 1980s. The reason for this is that we have shipped many cyclical manufacturing jobs offshore to China, India, and others. In past recessions, the U.S. had a much larger percentage of its job market tied to manufacturing. Today, manufacturing jobs account for just 20% of the economy. Even in the unlikely event that 10% of manufacturing jobs were lost, that would mean just a 2% rise in unemployment. However, this is unlikely as many manufacturing companies that export internationally are experiencing growth due to a weak U.S. dollar.

We do, however, need to be somewhat skeptical about the seemingly resilient unemployment figures. A very different picture emerges when one distinguishes between private sector and government-supplied employment. The U.S. saw a decline in the private sector workforce in early 2008 for the first time in five years. The government has been keeping unemployment in check since mid-2007.

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GOVERNMENT EMPLOYMENT/PRIVATE SECTOR EMPLOYMENT



Source: Bureau of Labor Statistics

While it has been the government in past recessions that has lessened the unemployment woes while the private sector recovered, today the U.S. fiscal system is already stretched by the military operations in Afghanistan and Iraq. The U.S. government may not have the wherewithal to buoy unemployment for an extended period of time as it has in previous economic downturns.

BABY BOOMERS HEADED INTO RETIREMENT

Unlike previous recessions, we are entering a demographic tidal wave that could seriously change trends in consumer spending for many years to come. The Baby Boom generation, commonly referring to those born post World War II from 1945 to 1963, has been a major driver of consumer spending over the years.

Baby Boomers are a market that cannot be ignored, with some statistics stating they account for almost a third of the U.S. population. As the Baby Boom generation has moved through their careers and built up their asset wealth, they have been the first group to be marketed to as a unique entity that can be defined by certain cultural and behavioral patterns. Many believe that this group has single-handedly kept us from times of recession while cutting short other more definitive eras of economic weakness. This is the first generation that has done measurably better in terms of economic wealth than their parents' generation.

With the first Baby Boomers having received Social Security in January 2008, questions begin to emerge. What will happen to the spending patterns of these people as they enter their "golden years"? Will their spending patterns continue as they have in pre-retirement as they have more health priorities and their cost of living rises every year just as they move to fixed incomes? With many of their own parents living longer, can they afford to keep multiple generations afloat? These are difficult questions.

In answering these questions, we must be reminded that we are talking about a generation of people that has acquired considerable wealth. Today we sit on the leading edge of what is expected to be the greatest transfer of assets in the history of

America. The economic boom of the 1990s created an unprecedented amount of personal wealth in America—estimated at more than \$33 trillion. Today's retirees constitute one of the richest segments of the U.S. population, with more personal wealth than any previous generation. Therefore, the fear that the social security and Medicare systems will see unprecedented strain may be muted by this large sum of wealth.

Also, recall that today's retirees are the first beneficiaries of medical advances that have helped many live longer. Today's retirees have also been part of the generation that has focused more on health and activity than their parents' generation. They also want to have more fun—they ride Harley-Davidsons; they play golf into their 80s; they samba at their 60th wedding anniversaries.

So, while the demographics seem to suggest that we may be facing a large decline in consumer spending over the next 20 to 30 years as the Baby Boomers move through their twilight years, we argue that their accumulated wealth combined with their lifestyle choices should be able to sustain the solid spending patterns they have exhibited throughout their lifetimes. In fact, this group may even continue to be the ones to help us avoid significant economic downturns now and in the future. But alas, this will not last forever.

WEAK U.S. DOLLAR

Another difference in the U.S. economy versus previous recessions is the relationship between the U.S. dollar and other global currencies. But why is a weak U.S. dollar necessarily a bad thing for consumer spending?

ADVANTAGES

- U.S. firms find it easier to sell goods in foreign markets
- U.S. firms find less competitive pressure to keep prices low
- More foreign tourists can afford to visit the U.S.
- U.S. capital markets are more attractive to foreign investors

DISADVANTAGES

- Consumers face higher prices on foreign products/services
- Higher prices on foreign products add to higher cost of living
- U.S. consumers find traveling abroad more costly
- Harder for U.S. firms and investors to expand in foreign markets

As far as the consumer goes, the disadvantages of having a weaker U.S. dollar seemingly outweigh the advantages. While workers who are employed by companies that mainly export can benefit in terms of wages and job security, they are still paying the higher price for goods both domestically and abroad. A prolonged slump in the U.S. dollar should continue to weigh on consumer behavior and ultimately demand.

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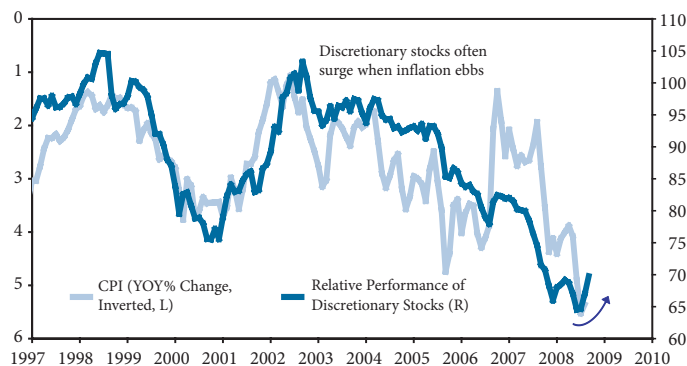
HOW DOES ONE INVEST IN THE CONSUMER SECTOR IN THIS ENVIRONMENT?

So, how does one navigate this sea of the unknown? What this paper has shown is that analyzing consumer spending is a multi-factor model with many variables that are constantly changing. What we have also learned is that, over time, there is reversion to the mean.

We believe that consumer spending will be constrained in the short to medium term. However, we also believe that the U.S. economy will emerge from our current doldrums through a combination of best and worst factors. Banks should begin to loosen lending restrictions to again allow business and real estate investment to grow. Housing should follow in stabilizing and eventually returning to its normal course of long, slow value appreciation. Commodity prices will eventually return to levels more indicative of true supply and demand rather than speculation. At this point, once we see a return of stability to the financial and housing markets, consumer confidence should rise as the wealth effect takes hold. Once consumer confidence rises, we usually see consumer spending return in a fairly expeditious manner. However, given the turmoil seen in the credit markets in 2008, we believe the timing of this recovery could be longer than in the past given the severity and depth of this crisis.

up; unemployment reaching high levels; GDP trending lower—consumer discretionary stocks typically begin to outperform the overall market. This usually takes place in a 12-month period before the actual fundamentals show improvement. The preceding graph shows the correlation between the Consumer Price Index and consumer stocks.

CORRELATION BETWEEN CPI AND CONSUMER STOCKS



Source: ISI Group

Further, consumer stocks usually lead after a weak market. As we enter an era where financial markets are in chaos, with the names of historic firms such as Bear Stearns and Lehman Brothers either getting swallowed into other entities or going into oblivion, a feeling of fear has taken over investor sentiment. This has logically crept into the greater economy through workforce reductions that ultimately affect consumer spending patterns. This should have obvious negative economic consequences over the short-to-medium term. However, as history has shown us, when economic factors look their most dire—inflation creeping

CORNERSTONES OF OUR INVESTMENT PHILOSOPHY



So, how does one invest for the long term given the ebb and flow of the economy and consumer spending? Kayne Anderson Rudnick prides itself on high-quality investing, with an emphasis on buying what we believe are strong businesses with attractive qualitative and quantitative characteristics resulting from business models that have sustainable competitive advantages through good times and bad. Let's examine the four cornerstones of quality.

Market Control

Market control is a company's ability to protect its market position and competitive advantage through a unique business characteristic. This can be achieved through superior brand equity; a built-in network effect that provides operating leverage; or being a low-cost provider of value-added services. We believe that the companies with market control can sustain themselves through difficult economic times better than others with short-term advantages.

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Management Excellence

Management excellence is exemplified by management teams that adhere to a more disciplined strategy in running and growing their businesses and tend to avoid the pitfalls of those that grow at all costs. We like to see how management has acted in previous economic downturns and how they allocate capital in these times. In the event a business experiences a large drop off in demand, and how management reacts to it, remains as important as growing in healthy times.

Financial Strength

The two previous quality attributes, market control and management excellence, should translate into financial strength in the form of strong cash flow used for reinvestment; low debt requirements that enable the companies to run their businesses efficiently and not be beholden to the capital markets; and low capital intensity to leverage their growth with minimal incremental investments.

Consistent Growth

Market control, management excellence, and consistent growth should create the effect of a business that has consistent, durable earnings over a long period of time with the potential to generate solid returns on capital. It is these returns that should give these businesses the ability to withstand economic hardships better than its less efficient peers.

Specifically, in the consumer sector, there are many companies that are subject to the whims and desires of customers with fleeting tastes. For example, in the retail industry, we tend to avoid clothing retailers that are subject to “fashion risk” over an extended period of time—dealing with inventory and manufacturing issues in trying to keep up with the latest trends. Instead, we prefer to own companies which own the licenses to several strong clothing brands and collect fees from the retailer—thus eliminating this risk and guaranteeing a minimum revenue stream.

In addition, we look for companies that can provide a true value-added aspect to an industry whether the consumer is spending or not—such as bringing together the highly fragmented customer and supplier markets. One of our holdings has been called the “eBay of the Salvage Auto Auction Market” with its virtual bidding platform that allows buyers from all over the world to bid on salvaged autos provided by insurance companies from throughout the U.S. Again, this is a business not reliant on the vagaries of consumer behavior.

Other companies we own in this sector provide goods or services that do not vary much with the economy and consumer spending, such as a company that makes bronze memorials and caskets or a company that publishes scientific and medical journals or a company that provides pest-control.

While we have found that it is not always possible to hedge yourself 100% from market downturns and severe consumer volatility, we believe that building an investment portfolio of high-quality companies will provide higher returns with less risk over the long term compared to a portfolio consisting of momentum-driven, market-timing dependent stocks.

THE END?

As we said at the beginning of this paper, everyone is a consumer. We all have our opinions as to what motivates us to spend or not spend. What we hope to have accomplished with this paper is to broaden your horizons on not only the importance of the consumer to the U.S. economy, but also to clarify our position on what we see going forward.

We believe that our investment philosophy bodes well for the volatile environment to which consumers have been exposed. While trying to time any recovery is difficult at best, our philosophy should pay off through these nervous times.

We thank you for taking the time to read this paper and we welcome any questions or comments you may have on this topic.



Data included in this paper was obtained from a variety of sources, including The Wall St. Journal, Bloomberg, FactSet Research Systems, Standard and Poor's, Bureau of Labor Statistics, Organization for Economic Co-operation and Development, Bureau of Economic Analysis, CNN.com, Harvard University Joint Center for Housing Studies, MortgageNewsDaily.com, Los Angeles Times, suite101.com, Central Statistics Office, Marketoracle.co.uk, Oilcrash.com, Time, Pittsburgh Tribune, National Bureau of Economic Research, NPR.org, MSNBC, Insurancejournal.com, and International Strategy & Investment (ISI). All data is assumed to be reliable.

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ABOUT THE FIRM

Kayne Anderson Rudnick

Kayne Anderson Rudnick Investment Management, LLC is a registered investment adviser based in Los Angeles, California. The firm's clients include high-net-worth individuals, endowments, foundations, corporations, public funds, and pension plans for who it manages a range of portfolios having a common disciplined, high-quality investment philosophy.

The KAR Cerebrate series is designed to provide informative, thoughtful, and timely insights into key economic and financial-markets issues to help guide investors in today's complex world. Speak to your financial or portfolio adviser to learn how we can help you reach your financial goals.

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