



The Long-Term Case for Consumer Staples

By Fayez Sarofim & Co.

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Executive Summary

At Fayez Sarofim & Co., we have long appreciated the multiple benefits Consumer Staples stocks can have on a well-diversified portfolio. Long-noted for their protective qualities in difficult economic and financial environments, Consumer Staples stocks can offer a moderate risk approach to pursuing superior real rates of growth.

Many investors, investment strategists and the financial press seem to discover Consumer Staples only during periods of stock market stresses like we are currently experiencing. True to form, Consumer Staples was the best performing sector of the S&P 500 in 2008 when global equity markets suffered one of the worst downturns since 1931. However, we believe that by narrowly focusing on the sector's attractiveness only during down market periods, many investors miss the long-term case of owning these stocks.

We believe there are three main characteristics that make owning many Consumer Staples stocks beneficial: 1) Consistent, predictable record of profit growth, 2) Long duration global growth opportunities and 3) Strong financial characteristics. The combination of these factors enables these stocks to generate the profit stream that makes these holdings attractive for long-term investors. As such, we will look at each of these factors in greater detail.

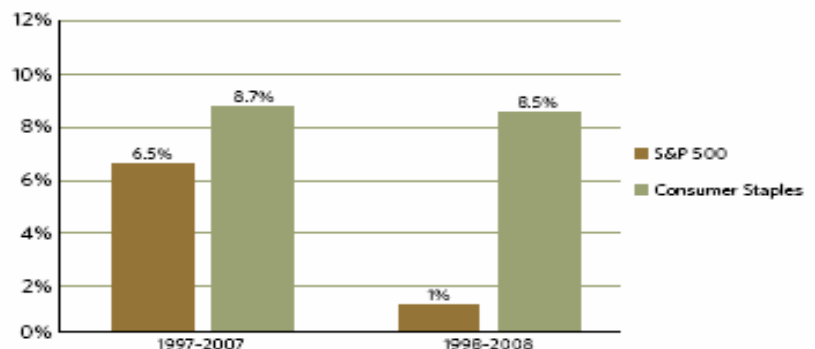
Consistent, Predictable Profit Growth

We are attracted to both the historical *rate* and *consistency* of earnings growth in this sector.

The rate of earnings growth tends to exceed market averages over long periods of time (see Chart 1). Solid earnings growth is driven by:

- Brand loyalty, which protects market share and pricing power and encourages trial of

Chart 1 Annualized EPS Growth



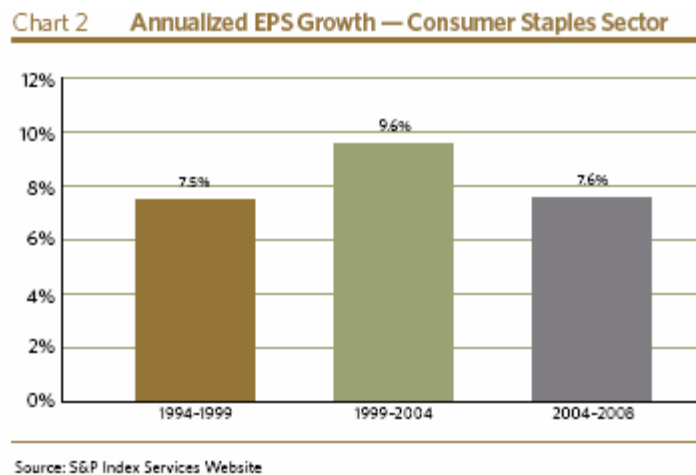
Source: S&P Index Services Website

innovative product upgrades.

- The global nature of demand for staple products coupled with rising disposable income levels in emerging markets.
- Reliable, albeit modest, margin expansion stemming from the predictability of demand and management teams focused on efficiency of operations.

The *consistency* of earnings growth historically has differentiated the consumer sector from other more economically sensitive sectors. As you can see from Chart 2, the rate of earnings growth remains remarkably steady throughout different time periods. Stability and consistency are driven by:

- The fundamental nature of the products, such as detergent, toothpaste, cigarettes, soft drinks, juices, packaged foods and snacks, toilet paper, cosmetics and beer, which are purchased on a weekly/monthly basis and are used daily. Because these products are of a more essential nature, demand is much less cyclical than in durable/discretionary product areas like automobiles, appliances, apparel and home furnishings. Although consumers can empty their pantries before repurchasing, or cut down modestly on consumption, demand is relatively stable for these frequently used products.
- The generally low price point of these items relative to big ticket purchases also makes Consumer Staples products less of a target of household budget cuts.
- Most of the product categories are global in nature, and are therefore less dependent on any one geographic market.



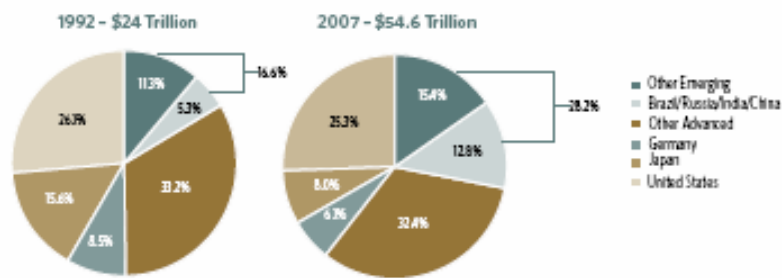
The consistent historic earnings growth profile of the Consumer Staples sector is particularly valuable in today's environment of rapidly deteriorating corporate profits.

Long Duration Global Growth Opportunities

We feel that many Consumer Staples companies can maintain strong growth rates because of the vast global opportunities to sell their products, especially to the emerging markets consumer.

The emerging markets provide a multi-decade growth opportunity for well-capitalized multi-national Consumer Staples companies. Despite the current global economic slowdown, emerging markets continue to offer significant long-term growth opportunities. China, in particular, is in the midst of an extended industrialization and urbanization process. Also, in the aftermath of the credit crisis, market share and earnings power are likely to be even further concentrated in the industry-leading multi-nationals. As Chart 3 shows, over the last 15 years, the contribution of emerging market countries to world GDP expanded from 16.6% to 28.2%. We expect the emerging economies to continue to grow faster than the advanced economies in the forthcoming decade, and would anticipate that these developing markets will contribute over one-third of global GDP within this time frame.

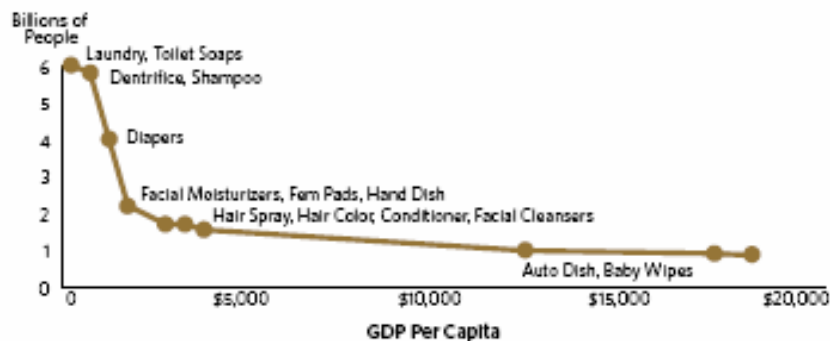
Chart 3 Global GDP



Source: International Monetary Fund, World Economic Outlook Database, October 2008
U.S. Census Bureau, Population Division

Specifically, as GDP grows in developing markets, disposable income levels will rise, potentially benefiting the Consumer Staples companies that have established operations in emerging markets like China and India. After providing for basic necessities of shelter and food, staples are the next use of discretionary cash flow, as consumers start to buy these basic household items to enhance their quality of life (see Chart 4).

Chart 4



Source: Procter & Gamble

Because the products sold in the emerging markets are largely the same products consumed in developed markets, the Consumer Staples companies enjoy tremendous

economies of scale. If revenues can grow 4% - 6%, but SG&A growth is limited to 2%-4%, the companies can deliver steady margin expansion.

Companies like Coca-Cola, Procter & Gamble, PepsiCo Inc., Nestle and Philip Morris International are committed to continuous innovation in their product categories. Because they generally have the No. 1 market share position, they can afford to invest more into research and development, as well as marketing and brand support, than can their competitors. Successful innovation protects and expands market share, and frequently serves as a mechanism for pricing power. For example, several years ago, Procter & Gamble replaced its Pampers Premium diaper line with Pampers Baby Stages. The new design enhanced product performance and enabled a 10%-20% price increase. The profit margin on the new line is higher than the old, so P&G's profit per diaper increased significantly from this innovation. At the same time, the new diapers drove category trade-up, meaning more consumers shifted from basic diapers to these premium diapers because of the product appeal.

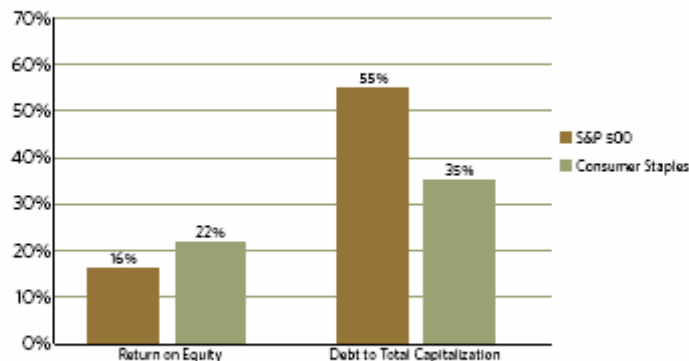
Finally, Consumer Staples companies are generally not threatened by obsolescence. Whereas in some industries, such as technology, it is difficult to project whether the products will be needed in 10-20 years, for most Consumer Staples categories, in our view, there is great certainty that the world will be consuming the products for decades to come.

In the current environment, the developing economies are slowing along with the rest of the world, as this recession is global in nature. With that being said, some of the Consumer Staples sectors continue to grow at fairly attractive absolute dollars rates, despite the slowdown. For example, the household products and personal categories in which Procter & Gamble competes continue to grow 5%-6% in the developing markets. While this represents a slowdown in growth from recent years, it is still positive growth as compared to other industries that experiencing significant declines in demand. Thus, we believe it is a positive for Consumer Staples to be operating in markets that can continue to grow through the recession

Strong Financial Characteristics

A strong financial position is always important to a corporation, but in poor economic environments like today, it becomes essential to companies that are trying to grow. Strong balance sheets with low debt levels, high return on equity and significant free cash flow generation are key drivers of our affinity toward the Consumer Staples sector (See Chart 5).

Chart 5



Sources: S&P Index Services Website

The generation of positive cash flow is particularly important in the current market environment as funding for companies across all sectors has become scarcer during the credit crunch. Brand loyalty, pricing power, global product appeal, relatively stable demand and a continuous focus on costs are among the factors that enable Consumer Staples companies to generate cash flow, which can be used to fund operations through various stages of the business cycle.

Additionally, the management teams in the sector have generally been good stewards of capital. Free cash flow in the sector is typically used to: 1) make opportunistic acquisitions, 2) pay out significant, growing dividends, and 3) fund timely, value-added share repurchase. As illustrated in the table below, the cash returned to shareholders is significant, which is one of the most attractive investment merits for the sector.

	2006-2008 3-Year Total	% of 12/31/08 Market Cap
Dividends	\$61B	9.7%
Share Repurchase	\$61B	9.6%
Total Capital Returned	\$122B	19.3%

Using Altria, Coca-Cola, Nestle, PepsiCo, Philip Morris Intl. and Procter & Gamble to illustrate. Results for other Consumer Staples stocks would be different.

Manager Perspectives

While generally speaking, the above-mentioned characteristics are possessed by many of the individual companies comprising the Consumer Staples sector, it should be noted that due diligence is recommended to avoid those that do not. Active management supported by a strong research effort can protect against owning those companies that are trapped in slow-growth categories, losing market share, are U.S.-centric, or which do not have strong financial positions. For example, supermarkets have been steadily losing market share to other retail formats for years, and operate in a very low margin business. Many of the commodity food companies face continual pricing pressure and derive the majority of their revenues from the U.S., and therefore are not participating in global growth opportunities. Lastly, domestic soft drink bottlers serve as an example of a capital intensive subsector that requires high debt levels to run their businesses.

We recognize that many market participants are currently investing in the Consumer Staples sector as a place to hide in a turbulent market. We want to be clear that the Consumer Staples sector is a long-term strategy for professional money managers that value their fundamentally attractive business models in good times and in bad. We believe that the companies in this sector can grow their earnings at a superior rate for a long period of time. We are, of course, cognizant of the valuations of these companies, but feel that the premium that this sector typically commands is warranted. We are quite comfortable with the absolute and relative multiples for the Consumer Staples sector today. In fact, the relative multiple has contracted significantly over the past few months as

downward earnings revisions have been for the broader market, where S&P 500 consensus earnings estimates have declined 35% since October and continue to fall.

In difficult environments such as we are in today, the Consumer Staples sector provides added benefits of transparency and simplicity. Investors can understand what these companies do and how they make their money. We understand why the products are in demand because we purchase and use most of them on a regular basis. The companies have long histories of profitable operations. There has been little change to their overarching strategies, and we understand what these strategies are. Their net earnings are real and convert to free cash flow. And they tend to use this cash flow to the benefit of shareholders.

We believe the case for Consumer Staples stocks rests not only on their defensive characteristics in turbulent times, but also on the ability to participate in global growth opportunities that may unfold in the future.

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Investing internationally involves special risks, including changes in currency exchange rates, political, economic, and social instability, a lack of comprehensive company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries than with more economically and politically established foreign countries.