

Viewpoint

Baird Investment Management (BIM) manages high-quality portfolios for high-net-worth individuals and institutional clients.

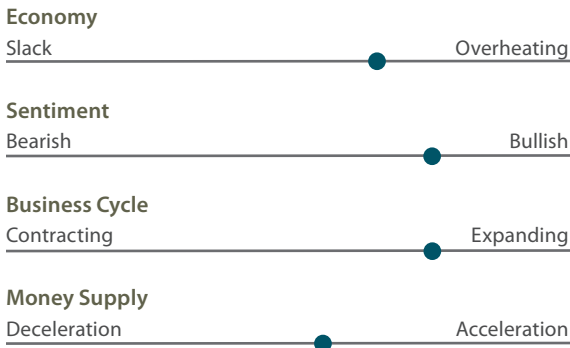
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Baird Investment Management

“Kilometers are shorter than miles. Save gas, take your next trip in kilometers.”

- George Carlin

Market barometer



Source: MTI, Investors Intelligence, Bloomberg

Market update as of 5/31/11

	MTD	YTD	Trailing 12 Months
Dow Industrial Average	-1.5%	9.8%	27.3%
S&P 500	-1.1%	7.8%	26.0%
Russell 1000® Growth	-1.1%	8.4%	29.4%
Russell MidCap® Growth	-0.4%	11.4%	36.3%

Source: Russell, APL

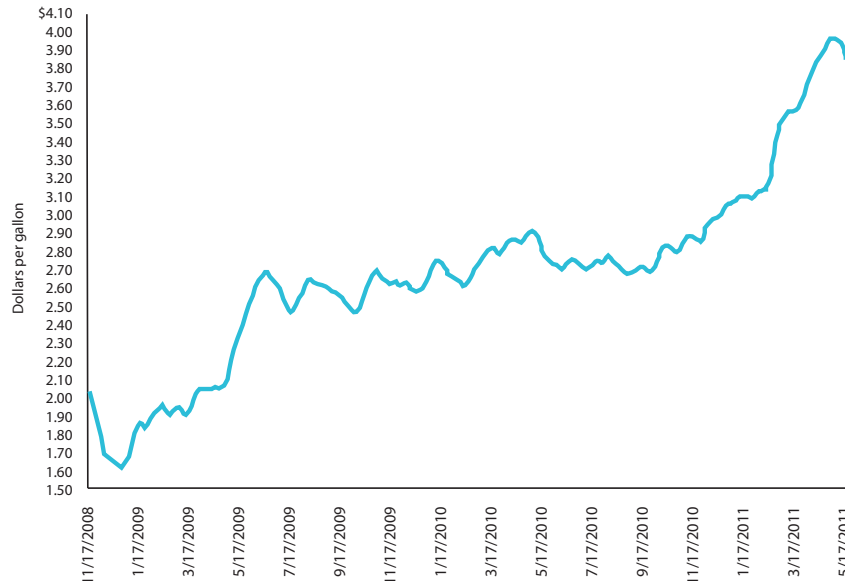
How much are higher gas prices hurting the consumer?

The recent run-up in gasoline prices has us contemplating how higher fuel costs might affect consumer behavior. Our conclusion is that it has resulted in the average consumer losing approximately 3% of their spending power, causing them to reign in their spending and focus on needs rather than wants.

To frame the problem specifically, the chart below shows that gas prices have risen dramatically over the last couple of years – more than doubling since the beginning of 2009 (from a low of \$1.60 in January 2009 to a high of almost \$4.00 in April 2011).

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Weekly U.S. Retail Gasoline Prices, Regular Grade



Source: Energy Information Administration

Breaking down the gasoline inflation a bit further, we calculated the impact that higher gas prices have on actual household incomes. The chart below plots various miles-per-gallon (MPG) scenarios versus different price-per-gallon (PPG) assumptions. For calculation purposes, we assume that the average vehicle drives 12,000 miles per year. Using the current combined city and highway national average MPG of 20 and a PPG of \$4.00, we can see that the average household is paying \$2,400 per car, per year, in gas expenditures, compared to \$1,650 just one year ago (using 20 MPG and a PPG of \$2.75). This means that over the last year, a \$1.25 increase in gasoline prices has cost the average household approximately \$750 per car. Considering that the average household owns two cars, they have \$1,500 fewer dollars to use on other items they may need or want. Lastly, the U.S. Labor Department estimates that the average household earns \$62,857 before taxes and spends \$49,067 per year.¹ Under this scenario, higher gas prices consume an additional 3% of the average household's spending ability per year compared to one year ago.

Miles per Gallon vs. Price per Gallon

	20	22	24	26	28	30
\$2.00	\$1,200	\$1,091	\$1,000	\$923	\$857	\$800
\$2.25	\$1,350	\$1,227	\$1,125	\$1,038	\$964	\$900
\$2.50	\$1,500	\$1,364	\$1,250	\$1,154	\$1,071	\$1,000
\$2.75	\$1,650	\$1,500	\$1,375	\$1,269	\$1,179	\$1,100
\$3.00	\$1,800	\$1,636	\$1,500	\$1,385	\$1,286	\$1,200
\$3.25	\$1,950	\$1,773	\$1,625	\$1,500	\$1,393	\$1,300
\$3.50	\$2,100	\$1,909	\$1,750	\$1,615	\$1,500	\$1,400
\$3.75	\$2,250	\$2,045	\$1,875	\$1,731	\$1,607	\$1,500
\$4.00	\$2,400	\$2,182	\$2,000	\$1,846	\$1,714	\$1,600
\$4.25	\$2,550	\$2,318	\$2,125	\$1,962	\$1,821	\$1,700

How does reduced household spending ability affect the consumer? We believe the simple answer is that higher gas prices cause the average household to scrutinize their purchases more to ensure they meet their needs and forgo the wants they can no longer afford. Importantly, we believe we are starting to see this spending shift play out in the dollar stores, a traditionally low-end-focused category of retail stores. In fact, recent commentary from one dollar store chain indicated that discretionary spending was down in its stores, giving way to higher consumable sales (more "needs" versus "wants" purchasing). Additionally, store profit margins recently decreased due in part to increased commodity prices and transportation costs coupled with the company's inability to raise the prices it charges its struggling customers.

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Given our belief that higher gas prices are affecting the average consumer, we have been adjusting our stock picks to focus on areas of consumer need while lessening our portfolio's weightings of consumer wants. This thought process has led us to look for more investments in the consumer staples area, such as companies that sell food or cleaning products (e.g., PepsiCo and Proctor & Gamble). It has also led us to stocks that offer unique products that save consumers money (private label products), offer more one stop shopping (e.g., Wal-Mart) or allow the customer to save a costly trip to a physical store location by shopping online (e.g., amazon.com). Other areas of investment interest are products that are consumed at home, such as cable network companies or movie services (e.g., Scripts Networks, the parent of the Food Network and HGTV).

Our long-term investment focus continues to seek companies that display qualities such as high profitability, greater-than-peer revenue growth, participation in industries that have economic winds behind them, strong and experienced management teams and reasonably forecasted company expectations. However, within our long-term investment framework, the higher price of gas has temporarily changed consumer's buying habits. In response, we currently find ourselves subtly shifting our investment focus toward companies that provide households with more needs than wants in this tough consumer market environment.

To learn more about Baird Investment Management (BIM) and our products, please contact us at 800-792-4011 or 414-765-7246. Visit us online at bairdinvestmentmanagement.com.

¹CreditLoan.com, "How the Average Consumer Spends Their Paycheck." Available at: creditloan.com/infographics/how-the-average-consumer-spends-their-pay-check/, October 2010.

This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee accuracy.

Securities should not be purchased solely based on the dividend rate.

The S&P 500 Index is a representative sample of 500 leading companies in leading industries of the U.S. economy. The Russell 1000[®] Growth Index measures the performance of those Russell 1000[®] companies with higher price-to-book ratios and higher forecasted growth values and is a large-cap index. The Russell Midcap[®] Growth Index measures the performance of those Russell Midcap companies with higher price-to-book and higher forecasted growth values. The stocks are also members of the Russell 1000[®] Index. The Dow Jones Composite Average Index is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. Indices are unmanaged, and an investment cannot be made in one. Past performance is not a guarantee of future results.

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