

When will the world learn to grow up?

AT A GLANCE

- Demographics has the power to influence investment markets
- The developed world's challenge is to balance top-heavy and shrinking populations...
- ...while the developing world must manage booming and demanding populations hungry to consume
- Both situations are manageable if we are willing to adapt to them
- Both present investment opportunities to well-prepared investors

Demography, or the statistical study of human populations, has a large, somewhat undefined influence on investment markets. Ageing populations in developed countries contrast sharply with growing and increasingly wealthy populations in the developing world. The way these changing populations live their lives and spend their money has the power to shape economies and can prove to be an irresistible force on investment markets.

Changing trends in the world's population, understood through demographic data, could provide some clues as to what may power markets in the future. Understanding the influence of demographics on investment markets recognises that much greater forces than simple corporate profits, economic cycles and investor behaviour are at play on our investments. It is impossible for investors to influence demographic trends, but it is possible to prepare for and exploit them.

CAN DEVELOPED MARKETS SUPPORT THEIR TOP-HEAVY POPULATIONS?

Developed countries have undergone what is known as a demographic transition. This describes the progression from the high birth and mortality rates of a pre-industrialised economy to the low birth and mortality rates of developed economies. Rising wealth and health means people live longer and a demographic paradox means that, as a nation's wealth increases, its birth rate falls. This paradox has prompted some people to point out that a government's best tactic to tackle a high birth rate is to encourage economic growth. Who would have thought that economic growth could be an effective contraceptive?

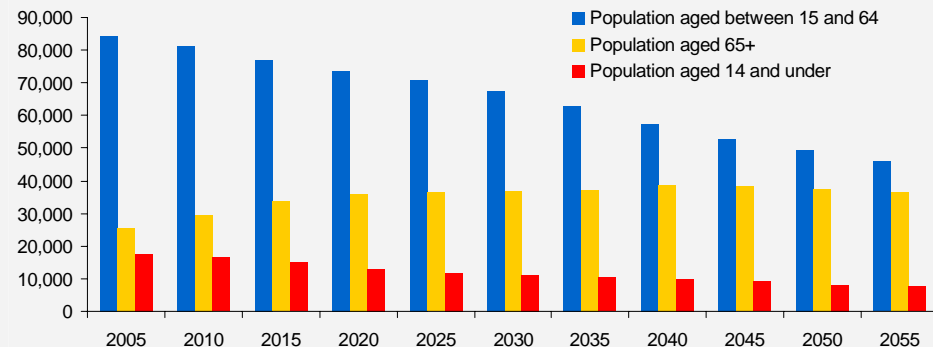
MIDDLE AGE IS SPREADING

With birth rates declining and people living longer, developed nations' populations are getting older and, in some cases, smaller. Japan is the extreme example, where the population is expected to have peaked in 2007 at around 127 million, before it falls below 100 million within 40 years. Japan has two significant waves of baby boomers, the first of which are retiring right now with many more to follow.

At the moment, almost two-thirds of Japan's population is of working age (15-64), while nearly a quarter is of retirement age. By 2050, just half the population will be working, and almost 40 per cent will be retired (or of current retirement age). Putting this another way, currently 3.3 people are working to support every retired person. By 2055, there will only be 1.3 people in work for each retired person.

The economic impact of these two trends is obvious and not confined to Japan. A shrinking population implies a shrinking economy, and whatever wealth the declining working population is able to generate will be increasingly focused on the growing dependent retired population. Perhaps the greatest concern is that, in spite of the ample warning, the Japanese government seems reluctant to act.

JAPAN POPULATION PROJECTIONS



Source: Population Projections for Japan 2006-2055, The Japanese Journal of Population Vol. 6 March 2008

JAPAN'S SHRINKING POPULATION

- Japan's demographics pose a real challenge to the country
- Between now and 2055, Japan's population will shrink from almost 130m to less than 90m
- At the same time, the working population reduces from two thirds to just half...
- ...and the proportion of retirees doubles from 20% of the total population to 40%

“We know for sure that people are ageing everywhere and becoming wealthier in the emerging markets. This is a huge driver to the healthcare industry as by a long way, these two dynamics grow faster than GDP and present some very interesting investment opportunities.”

Hilary Natoff, Portfolio Manager

IS JAPAN A BASKET-CASE?

Even if you read some of the statistics about Japan and conclude it is a demographic basket-case, you still should not give-up on its investment potential. For all the influence of population shifts in investment markets, Japan remains a stock-pickers market. Japan is home to some of the world's leading companies, at the top of their game in technology and efficient manufacturing, doing business in every continent and with a unique geographical advantage over some of their western competitors. Put it this way, would you be put off an investment in Canon, or Honda – two of the strongest global brands, for whom borders are no object – just because the Japanese population is top-heavy?

THE DEVELOPING WORLD MUST GET RICH BEFORE IT GETS OLD

The developed world's challenges stem from top-heavy populations, but they do at least have the economic foundation to support them. Emerging markets do not. This is especially the case in China where the one-child policy means China's population pyramid looks more like a population funnel (much like Japan's in 2050). Since the 1970s, most people in China have been restricted to one child per family. This draconian measure has put a lid on China's booming population and helped the country control its growth more carefully. But critics suggest that it simply postpones economic problems and will mean a generation of Chinese people will have to shoulder the potentially crippling burden of supporting two parents alone. Putting it simply, China must get rich before it gets old.

CAN BABY BOOMERS BLOW BUBBLES?

Anyone who doubts demographics' influence on investment markets should study carefully the correlation between the passage of the baby-boomer generation through the decades and US equity valuations. The US baby-boomer population is the largest cohort of its type in the world, being in the region of 78 million people. While each individual within that group makes their own decisions, they all will pass through life guided by the same common motivations such as the desire to earn and save. In such vast numbers, any common behaviour can be very powerful and through the 90s this group were at the peak of their earning and savings potential.

WHAT DIFFERENCE DOES DEMOGRAPHICS MAKE TO INVESTMENT MARKETS?

Analysis of the 1980s and 1990s equity bull market reveals a startling correlation between the demographic trends and the market's behaviour. As the number of wage-earning 35-54 year-olds, at the height of their savings habit, increased through that period, the number of people retiring (and in theory ending their asset accumulation habits) fell.

This phenomenon is the subject of Barclay's annual study of market returns, which argues that the two bubbles of the past decade - the dot.com bubble which burst in 2000 and credit bubble that led to the financial crisis - were caused by an imbalance of affluent baby-boomer investors and investment opportunities available to them.

Most US workers' retirement savings are tied to stock markets through widespread 401k work-based retirement savings schemes. The Barclays study suggests that the world's investment markets were unable to deal efficiently with an abundance of wealthy developed-market savers looking to invest in too few opportunities. The growing influence of this mass of invested money pushed equity valuations higher and so led said investors to pay more for riskier investments.

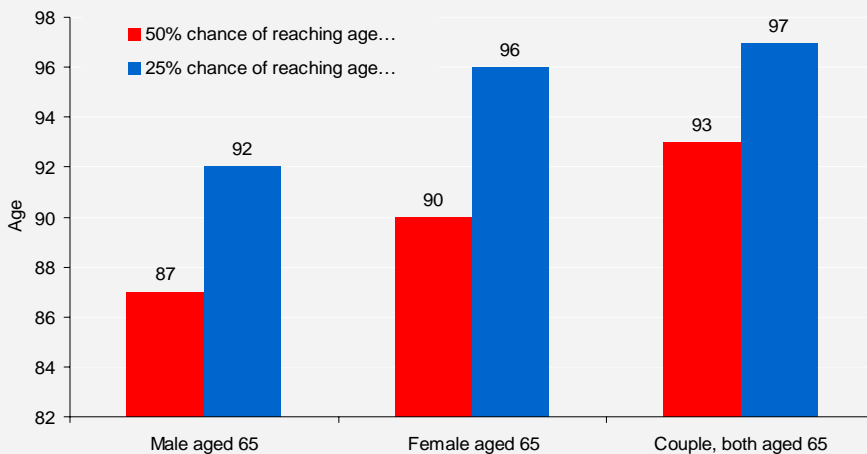
DON'T BLAME TECH FOR THE BUBBLE

Too much money chasing too few opportunities inevitably led to the inflation of the late-90s technology bubble. The study points out that it was demographics, not technology, that caused the bubble. Dot.coms and other “new world” investments in media and telecoms just happened to capture investors' imagination and became their focus. It could easily have been another asset around which the bubble formed.

The authorities were determined for the crash - and its devastating impact on the nation's retirement savings - not to become an economic crisis and slashed interest rates in response. Those low rates encouraged excessive borrowing and, in turn, helped push asset prices higher again - especially house prices, chased up by the affluent home-owning boomers to such an extent that they eventually lost touch with levels of reasonable affordability. Because the US authorities effectively turned a blind eye to the rising levels of debt and the risk that posed to households, companies and lenders, as rates began to rise again, it was only a matter of time before something cracked.

What does this tell us about the future? The excessive valuations of late 90s' equities means the ten-year US equity return remains virtually flat. On two separate occasions in the past decade, investors have withdrawn from risk assets *en masse*. The natural assumption is that when risk appetite returns, these investors will return to equities. But because this retreat coincides with many of the baby-boomers approaching retirement and so reaching a stage in their lives where they begin to run down their riskier assets in favour of income-generating investments, that assumption may have to be tested. It is quite possible that much of the baby-boomers' funds never return to equity markets.

LIFE EXPECTANCY OF 65 YEAR-OLDS



Source: Fidelity, CMI Bureau. Calculated using PMA92 (Mortality tables published by CMIB), PFA92 base tables, medium cohort improvement basis, projected by year of birth.

WHEN I'M 94

However, the theory that, upon retirement, an investor's assets should immediately switch from growth to income assets could be short-sighted. A healthy man retiring at 65 has a 50:50 chance of spending 22 years in retirement. The odds that at least one member of a 65 year old couple will live to 93 are 50%; and 25% that one of them will make it to 97.

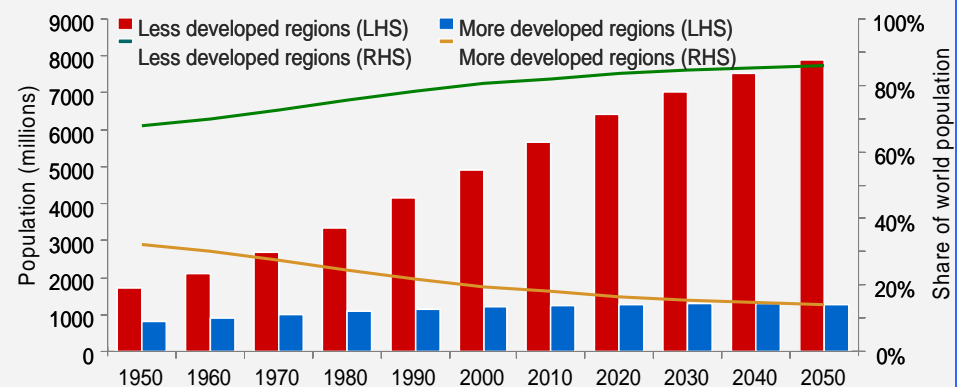
Facing a retirement of this length, newly-retired investors should be thinking as much about how they will make their assets last as long as them, as how much income their savings can generate. For this reason, there needs to be a shift of attitudes in retirees' asset allocation in favour of growth assets. This could mean some of the baby-boomers' vast collective wealth finds its way cautiously back into the growth market at some point.

While Barclay's assertions are interesting they do not provide irrefutable evidence that baby-boomers are the sole factor behind the past twenty years of market movements. Even the greatest advocate of their theory must recognise that other influences exist.

GROWING EMERGING MARKET POPULATIONS

While the problem for developed markets might be shrinking populations, the opportunity in emerging markets is them growing with young, working cohorts reaching their economic prime. The key 15-64 age population is reaching its peak in Russia, China, Brazil and Turkey and emerging market populations are representing a rising share of the global population.

THE EVOLUTION OF THE POPULATION EXPLOSION



Source: World Population Prospects: The 2008 Revision & World Development Indicators database, World Bank October 2009

OUT OF AFRICA

Growing populations in growing economies present a potentially vast investment opportunity, with an army of new consumers keen to enjoy their rising disposable income. So demographic change in these countries is as much to do with rising consumer power as it is population change. China grabs the headlines, but there are several unrecognised consumer stories in emerging markets that receive little or no attention. This makes them perfect stock picking opportunities.

Africa is often overlooked by investors who fail to recognise the unfolding consumption story on the continent. This is one of portfolio manager Nick Price's favoured investment themes, as he explains:

"Africa is one of the least researched of the emerging market regions and so hides some of the best value opportunities for pioneering investors willing to do their homework. Familiar emerging market investment arguments also apply to the continent, including consistently high GDP growth, the considerable and growing low-cost labour force and its rapid rate of productivity growth. And other secular trends support the region, such as the continent's fast-growing consumer sector."

"Africa's virtual competitive void is an opportunity for companies who provide for the continent's growing consumer population. Shoprite is a low-cost food retailer, based in South Africa, but with outlets in 17 African counties and beyond. Its coverage across the continent is vast and a staggering 60 million customers shop in its stores every month. It enjoys little competition and has grown a dominant position in its sector. Not resting on its laurels, it is expanding into Africa, with sales growing at 30% a year. Compared to its few direct competitors, it offers stronger growth credentials, as well as a stronger balance sheet."

ADAPTING TO SURVIVE

Any pessimistic analysis of demographics uses set assumptions based on today's common practice. Viewed through the eyes of today's legislators and retirees, longer lives and shrinking working populations are an expensive problem. But they need not be if governments, employers and employees adapt.

Why, for example, do we stick to a mandated retirement age around 65? Many of today's healthy 60-year-olds are as fit as their parents were at the age of 50 and are willing and able to contribute many more working years to the economy. As long as final salary pension rules assume that workers reach peak earnings at the age of 65 after a long and devoted career with one firm, employers and employees will continue to think of retirement as one particular day in the future when their life changes forever. Surely it is time for this outdated model to be smashed and for greater flexibility to be introduced that allows people with skill and experience to contribute more to the economy for longer.

With greater flexibility and concerted effort to adapt to the inevitable changes in national populations, demographic transition need not inhibit further economic development. And all the while enterprise is flourishing in a benign economy, investment opportunities can be found.

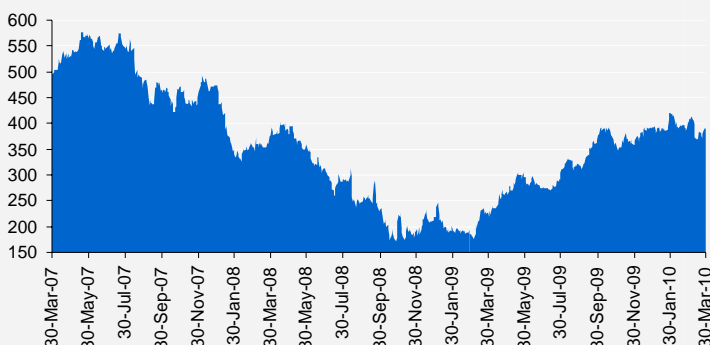
THE INVESTMENT OPPORTUNITY...

An investment in demographic themes can be relatively defensive. Demographic trends unfold over years and decades and, at many levels, are very predictable. They are also unstoppable, so, while short-term influences may blow a share's value off course, the underlying demographic theme endures.

The clearest investment opportunities to play on demographic themes are in healthcare and consumer industries.

The healthcare sector covers many companies, from drugs, through replacement body parts, to long-term care providers offering products and services to ageing populations.

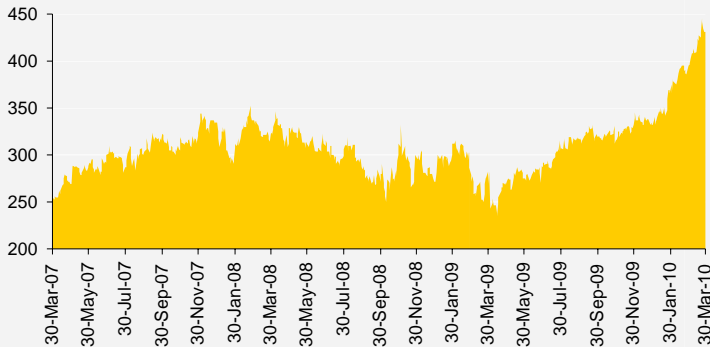
WILLIAM DEMANT



Source: Datastream, 31.03.10. Price return in local currency

William Demant is a Danish company and one of the world's leading hearing-aids makers. Longer life expectancy means not only more people have the need for hearing aids, but those that do require them for longer, often meaning the need for three in their life-time rather than the current average of two.

NOVO NORDISK

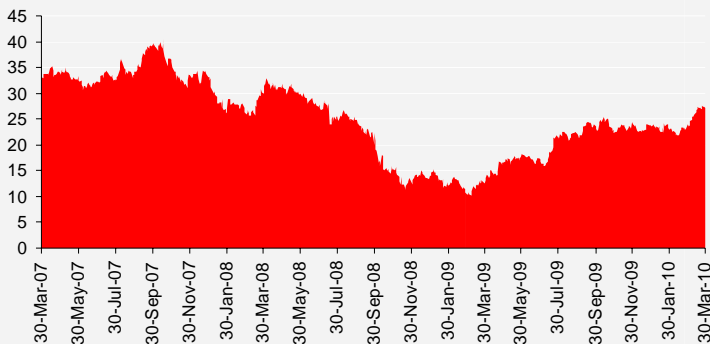


Source: Datastream, 31.03.10. Price return in local currency

Novo Nordisk is a leading maker of drugs for diabetes. Diabetes is a condition that is affecting growing numbers of people in the world who are leading lazier lifestyles tied to desks and eating convenience food. One of its fastest growing markets is China, where a side effect of urbanisation and wealth creation is an increase in the rate of diabetes.

The consumer industries sector, on the other hand, makes things for - and provides services to - the growing numbers of increasingly wealthy younger populations, especially, but not exclusively, in the developing world. Examples would include new technologies (or affordable versions of existing technologies), sportswear, luxury goods and education services.

eBay



Source: Datastream, 31.03.10. Price return in local currency

A less obvious play is peer-to-peer internet auction site eBay. The company is finding a foothold in countries where people have more stuff to sell and more people are keen to buy. This is a clear play on the growing influence of consumers in developing economies and their transition into 21st century (urban) lifestyles.

CONCLUSION

Analysis of the world's changing demographics is usually framed as a problem. For governments, this may well be the case but, for investors, it need not. Economic problems are often solved by solutions made in businesses and investors can make well-targeted investments to exploit this. A demographic-themed investment is best suited to an adventurous global investor, for whom international barriers are no object and who is able to employ thorough research and analysis to discover ideas that few others have found.

We know developing nations are getting older. We know emerging nations are growing in size and wealth. Both of these known facts present interesting investment ideas.

Without doubt, changing demographics will shape the world through the 21st century, a century which will end with a very different complexion to today. Investors who are able to go with this flow, and adapt their investments accordingly should embrace the changing world, not reject it.



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