

## INVESTMENT PERSPECTIVES

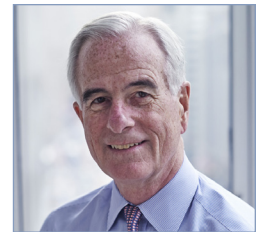
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# Glacial Change

Few economic variables change as slowly as population, yet demographic trends are among the most important determinants of a company's (or, for that matter, a nation's) growth over time. Like glaciers, demographics move predictably and inexorably. As investors, we pay attention to them not because they're relevant to forecasting near-term shifts in a company's fortunes but because it's helpful to know if they are in our favor or not over the long term.

Our recent client conference, *NOW (Navigating Our World) 2014*, included a presentation titled "Demographics and the Flow of Capital." Together with other sessions at the conference and a number of recent studies on the subject, it stimulated our thinking about the impact of population growth and resultant social changes on investing. In essence, demographic trends

suggest that global economic growth may decelerate, requiring even more careful research of specific stock ideas, but we believe that the emergence of a massive and growing middle class provides opportunity, particularly in the emerging markets.

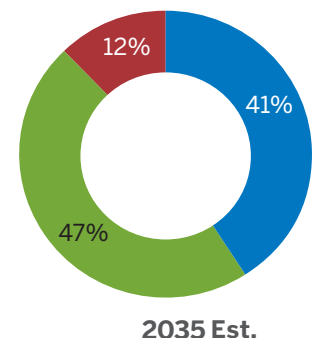
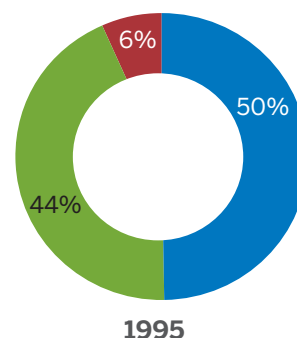
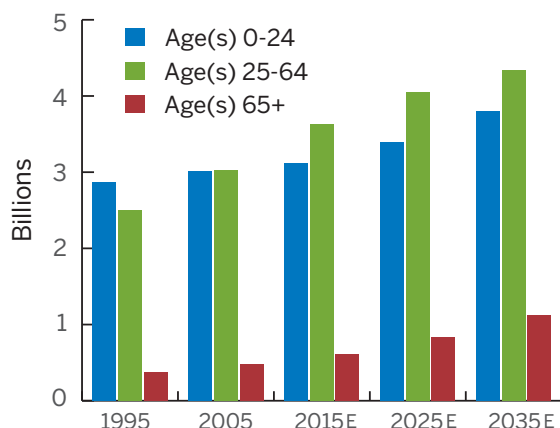


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### SLOWER GROWTH

Viewed in the broadest sense, the gradual slowing in the rate of global population growth has implications for the pace of economic expansion around the world. In the 20<sup>th</sup> century, for example, the globe's population

**EXHIBIT 1:** Aging of the Global Population



Source: UN Department of Economic and Social Affairs

doubled twice, but in the 21<sup>st</sup> century it's unlikely to double even once, as birth rates are declining. Within the overall figures, however, the changing distribution of the population by age group will inevitably affect how investors should be positioned for the long term.

Much has been written about the aging of the earth's population. Exhibit 1 summarizes this trend. As a percentage of the total population, people over the age of 65 have made up a relatively consistent 6 to 8% for the last few decades, but over the next 20 years that figure is expected to rise to about 12%, a substantial change. The two major factors behind this shift are declining birth rates and longer life expectancy.

Across the globe, birth rates are falling for a variety of reasons. As the world moves gradually from an agrarian-based way of life to a more urban one, families face a shift in the economics of child rearing. While children on farms are often viewed as an economic asset (helping to till the land, etc.), in the city they are less so. Further, improvements in the quality of health care (and access to it) mean that the chances of a child living into adulthood are greater, so families who continue to work the land typically need fewer children to ensure that their farms can be managed.

At the same time as birth rates are declining, people are living longer, mostly for the same reason: better health care. Whether defined by Social Security, corporate retirement plans, or simply decisions to stop working, the "normal" retirement age in the developed world has been slow to change. With life expectancies lengthening, therefore, a growing number of older people aren't drawing a paycheck.

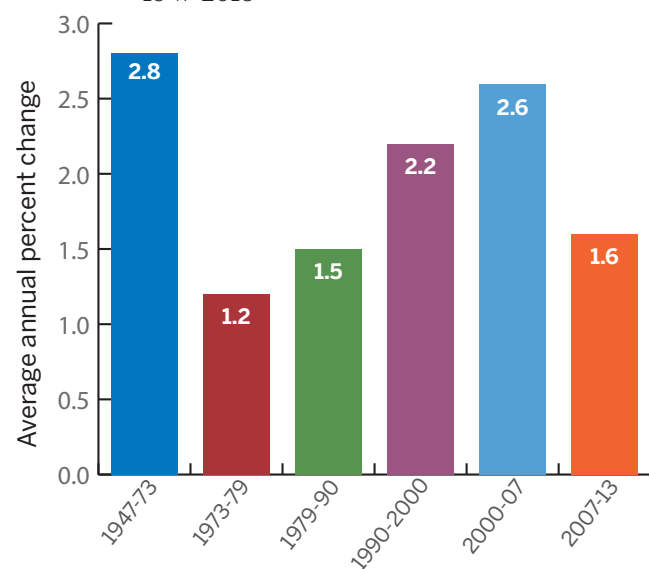
The ultimate impact of these changes should not be underestimated, although it will take many years to be fully felt by

companies and investors. One of the most far-reaching results of the aging phenomenon is that the global workforce is growing more slowly than it has historically. According to the Bureau of Labor Statics, over the last 20 years, the global workforce grew at a rate of 1.9% per year, but over the next 20 years the working-age population is expected to expand at a rate of closer to 0.9%. A full percentage point difference, compounded, can have a significant effect over time.

One might assume that an aging workforce would also imply a long-term decline in productivity, thereby further inhibiting economic growth, but that is not necessarily the case. True, some studies have shown that productivity tends to decline with age, mostly for reasons of gradually reduced physical and cognitive capacity. On the other hand, productivity measured in terms of relative earnings has been shown to increase at the upper age levels. An interesting 2013 study of the U.S. labor market by Gary Burtless of the Brookings Institution attributes this tendency to the higher educational attainment of older workers: Better educated, more productive workers tend to stay in the labor force longer than less productive ones, thus boosting productivity at the upper age levels. Rising educational levels may ultimately keep people working longer and more productively, helping to offset the graying of the population.

According to the Heritage Foundation, productivity in the U.S. has approximately doubled over the last 40 years through 2013 if measured in terms of output. Its rate of increase, however, has slowed slightly in recent years, for reasons that aren't entirely clear. Assuming that productivity growth stabilizes at around 2%, a more slowly growing workforce suggests that global GDP could expand at a pace that's lower than what most investors have come to expect. Specifically, instead of 2 to 3% GDP growth, the "new normal" might be 1.5 to 2%. The sluggish pace of the recovery in the wake of the 2008 financial crisis may be due partly to the influence of these factors combined with the massive deleveraging of the corporate and consumer sectors that has taken place since then.

**EXHIBIT 2:** Productivity in the Nonfarm Business Sector 1947-2013



*Note: Productivity is measured by comparing the amount of goods and services produced with the inputs that were used in production.*

Source: U.S. Bureau of Labor Statistics

## RISE OF THE MIDDLE CLASSES

While demographic trends suggest that overall economic growth is likely to moderate, shifts within the macroeconomic data provide reason for optimism about certain sectors. The rapid emergence of the middle class on a global scale, for example, was the main theme of our "Demographics and the Flow of Capital" discussion at our NOW conference in late April. Alan Murray, president of Pew Research Center, made the case that by 2030 the global middle class will expand to approximately 5 billion people, up from 2 billion today. ("Middle class" in the U.S. is based on middle income, or household income that is two-thirds to double the overall median household income. By definition, those in the middle class have some level of ability to spend on discretionary items.) While the U.S. and Europe make up a majority of the global middle class today, by 2030 those two regions will account for only about a quarter of the predicted 5 billion people. The spending power of an expanding

middle class around the world represents a huge opportunity for companies selling discretionary consumer goods.

Murray also talked about the evolving optimism of the middle classes, which could further drive spending. One measure of this attitude is the percentage of the population that believes their children will be better off than they are. Pew Research finds that in the developed world, 28% of people are “optimistic” by this measure, while in the emerging markets the figure is 58%—a huge disparity and one that has major implications for discretionary spending in different parts of the world. At a more micro level, it’s interesting to observe these measures by country: In the U.S., 33% of adults are “optimistic,” but in France only 9% and Japan 15%. In contrast, Nigeria is around 65%, Brazil 79% and China 82%.

Although the emerging world is optimistic about the future, the inequality of income distribution in many countries may pose something of a threat to social order. Generally speaking, as people move into the middle class, they become more aware of, and concerned about, this issue, according to Pew. Russia is a good example. The concentration of wealth among a relatively small number of oligarch billionaires was certainly a factor in the ouster of Ukraine’s former President Viktor Yanukovich and the ensuing unrest there. And China could face tensions as the rising middle class gains a clearer view of the power and lifestyle enjoyed by the very wealthiest. Already, the rich-poor gap is consistently among the three highest perceived problems in the country, behind only inflation and corruption.

#### BIRTH RATES AND AGE DEPENDENCY

Not all regions are affected by the rise of the middle class in the same way, as birth rates vary widely and affect the aging of the local population accordingly. In Japan, for instance, the fertility rate averages under 1.5 births per woman, meaning that the overall population is in significant decline and aging is a major issue. Much of Western Europe is faced with the same challenge, with Germany and Spain having fertility rates similar to Japan’s. By comparison, the emerging world typically has birth rates of 2.0 or higher, although there are exceptions like China, Brazil and Russia at 1.5 to 1.8. (The U.S. is about 2.0, which, combined with net positive immigration, means that the population is growing slightly.)

Varying birth rates lead to another way of assessing the impact of an aging global population: the “age dependency ratio.” This statistic measures the ratio of people older than 64 to those of working age, defined as 25–64. As shown in Exhibit 3, the global dependency ratio has risen steadily from 12.0 in 1950 to 16.0 in 2010 and is expected to increase to 23.2 by 2030—consistent with a graying population. Of course, the definition of “working age” is likely to change in the future as portions of the population work longer. Nonetheless, if history is any guide, laws governing normal retirement age, such as Social Security in the U.S., tend to lag actual aging trends, so a rise in this ratio would appear to foreshadow a major increase in the burden shouldered by working classes around the world as they support a growing number of the elderly. And, it’s important to note,

#### EXHIBIT 3: A More Dependent Population

##### Age Dependency Ratios, Selected Regions, 1950-2030

Expressed as the ratio of population over 64 to working age population, 25-64

	1950	1980	2010	2030E
<b>WORLD</b>	12.0	15.0	16.0	23.2
More developed regions	16.1	25.8	29.4	44.9
Less developed regions	9.7	11.5	12.5	19.2
<b>AFRICA</b>	8.7	9.7	9.6	10.6
<b>ASIA</b>	10.0	12.3	13.8	21.8
<b>Eastern Asia</b>	10.4	14.2	17.3	31.7
China	10.3	13.0	15.0	28.9
Japan	12.3	26.3	42.8	63.7
<b>EUROPE</b>	16.5	26.4	29.5	43.7
<b>Eastern Europe</b>	13.0	23.8	24.7	36.0
<b>Northern Europe</b>	19.8	29.8	31.0	43.8
<b>Western Europe</b>	19.5	27.7	34.3	51.8
France	22.5	29.4	32.1	48.8
Germany	18.2	27.0	38.1	56.8
<b>LATIN AMERICA AND THE CARIBBEAN</b>	9.4	12.9	14.4	23.2
Brazil	8.2	11.6	13.7	24.8
<b>NORTHERN AMERICA</b>	16.6	24.1	24.7	42.0
United States of America	16.6	24.3	24.6	41.5

Source: United Nations Population Division

these changes are likely to occur over what one could consider a reasonable investment horizon—about 15 years.

Behind the broad figures is a stark contrast between the “more developed” and “less developed” regions, which are forecasted to reach dependency ratios of 44.9 and 19.2, respectively, by 2030. We’ve shown selected countries and regions to provide a sense of how widely these ratios vary. Africa, Latin America and Asia are forecasted to have relatively low dependency ratios over the next 16 years, even though those forecasts represent a significant increase from current levels as people live longer in those regions. Over the same span, Japan and Western Europe, particularly Germany, are predicted to see very substantial increases in dependency from already high levels.

#### IMPLICATIONS

From an investment perspective, these seemingly glacial shifts in the landscape have important implications that should not be overlooked in the short-term market movements that so often dominate the headlines. At the same time, it’s not enough to invest purely on the basis of such long-term trends since such a strategy could mean missing the chance to profit from changes in the economic cycle, growth in particular sectors

and other similar factors. The trick is to be mindful of long-term trends—keeping the wind at our back, so to speak—while paying attention to valuation disparities and fundamental developments that create profit opportunities.

With that proviso, we see two broad implications of the demographic changes we've outlined above. First is the slowing of overall population growth coupled with the aging trend around the world. In light of this factor, it's hard to envision a scenario in which global economic growth will accelerate materially on a secular basis. As we've said, the relatively anemic recovery from the 2008-09 financial crisis may reflect this new reality. We would emphasize, however, that this does not mean that investment opportunities are hard to find. After all, a more moderate pace of expansion, coupled with low interest rates, is in some senses a "Goldilocks" environment for investing, neither too hot nor too cold.

Most important, our responsibility as investors is to take advantage of opportunities to make money for our clients, and even in a less robust economic environment we believe that those opportunities exist. A good example is our decision to emphasize small-cap stocks in our asset allocation advice to clients during much of the recovery, beginning in early 2009 through the end of last year. We then removed the "overweight" in small caps in recognition that they had reached relatively high valuation levels, leaving greater opportunity, in our view, in large caps and value stocks generally. On a more granular

level, it's our job to identify specific companies that have the ability to grow faster than their peers because they address rapidly expanding markets or have particular competitive advantages.

Our second takeaway from the demographic patterns outlined above is that emerging markets represent meaningful potential for long-term investment. Not only are the populations of many developing nations growing much faster than their developed counterparts, particularly Europe and Japan, but discretionary spending in the emerging world will likely be fueled by the rapid growth of the middle classes. In addition to consumption, the widespread adoption of technology should drive demand for technological innovation and help enable economic expansion through improved communications. This factor explains why we advise clients to have as much exposure to emerging markets equities as to developed international countries despite the fact that developed markets have a far greater proportion of global market capitalization. Moreover, equity valuations in the emerging markets are now below normal levels. We recognize that capital flows in and out of developing nations can cause significant volatility in those markets, but we believe that the long-term opportunity outweighs the added risk. And for those concerned about volatility, there are ways to mitigate risk, such as the use of hedged investments available to qualified investors.\*

In short, demographic trends provide a broad context for investing, influencing capital flows and in turn, securities prices. We should not ignore them. [B](#)

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