June 15, 2012

Dear clients and colleagues,

Demographics are an important theme in our investment process as we seek companies that will be favorably affected by demographic influences.

What often comes to mind when one talks about demographics is the rapidly aging population in North America. At Global Alpha, we try to have a broader perspective and look at the world. As an example, understanding the Echo or Y generation in North America is as important as understanding their parents, the Baby Boomers. The Echo generation was born between 1979 and 1991. In numbers, it represents 25% of the US population, or around 80 million people compared to the Boomers at 70 million. They have now finished university and are now entering the work force, influencing, among other things, rental dwellings, and many other goods and services. Many good books have been written on that subject.

Adult life is divided into segments. Adults in their 20s generally enter the work force, are single and have no children. Discretionary spending is high, savings low. The family years go from 25 to 55 years old. Spending mainly goes on the home and other necessities for the family and savings rate is low. The period from 50 to 70 years old is a mix of higher discretionary spending and high savings. Finally, the last 20 or so years are characterized by a reduction in spending and transfer of wealth.

The number of people in each segment is well known in developed markets. But what about emerging markets?

Today, China is 24% of the world's population. India follows with 21%. The rest of Asia (Vietnam, Indonesia, Philippines, Japan, Korea, etc.) is 20%. So 65% of the world's population today is in Asia. South America? Only 8%. Eastern Europe? 7%. Middle-East and Africa, also 7%.

But what about the age groups in those Asian countries and how they will change in the next 10 or so years to 2025? We used data from the United Nations as well as studies from the firm Global Demographics to analyze those demographics and reach some conclusions.

China has the most rapidly aging population among Asian Countries. In the next 10 years, the number of 0-39 year-olds will decline by almost 90 million people. Meanwhile, the number of people above 65 years old will increase by 70 million. That will have important consequences for the entire world. As China will see its labor force shrinking by more than 40 million people, it will seek to automate and increase productivity. As well, wages will rise and more production will go to other Asian countries, mainly South Asia and India. We are optimistic about the rise of consumption in China due to the increasing wealth of a rising middle-class but being aware of those trends that may lead us to find opportunities that cater to an aging population.

India is often thought of as offering better long-term prospects than China due to its better demographics, its English speaking population and the fact that it is a democracy. Looking at its population and labor force, one may agree. India will see its work force grow by 70 million people in the next 15 years. However, to have a real impact on discretionary spending, the percentage of the population that is working and the dependency ratio are key factors to consider. In 2025, over 50% of China's population will be working and the number of dependents per wage earner will be around 0.87 to 1, meaning more discretionary income. In India, those same numbers are 37% of the population working, supporting 1.65 dependents. In South Asia, it is even more, 1.85 dependents, leaving very little for discretionary consumption.

Looking at average annual household income, by 2025 China will be at around $17 000, India at around $8 000 and South Asia at around $5 000.

Although emerging markets are growing faster than developed markets, their impact on global consumption is and will remain relatively small compared to developed markets.

Currently, developed countries earn more than 80% of total world Income. By 2022, that proportion will still be 75%. The only country showing significant growth will be China, rising from around 7% today to 11% in 2022.

There are a lot of opportunities to invest around the world. At Global Alpha, our strategy has been to find good growth companies while minimizing risks. Our investments in emerging markets are diversified but have been concentrated on rising consumer spending. We tend to avoid those sectors that are deemed strategic such as natural resources, energy, technology or infrastructures in part due to government intervention in those sectors and the unlikely possibility of any foreign takeover.

Have a good weekend.

The Global Alpha Team