June 29, 2012

Dear clients and colleagues,

Last week we talked about the impact of demographics on our investment process. From a different perspective, its impact on the participants in the stock markets is also profound. We see three emerging drivers in the stock markets: pension reform, Generation Y, and developing countries.

Pension reform

A growing, aging population presents a huge solvency challenge on systems intended to provide financial security for the old. Pension funds struggle to meet rising liabilities. To make things worse, the financial crisis has created a vicious circle. On one hand, discounting pension obligations using the current historically-low interest rate balloons the liabilities; on the other hand, dropping asset values prevent pension funds from taking more risks, forcing them to sell stocks and buy interest-bearing assets. The questionable point is the discount rate, because pension savers usually don't draw down their funds for decades, leaving them less sensitive to day-to-day market fluctuations. This month we saw new initiatives based on a long-term view.

On Jun 7, Sweden put a floor on the discount rate pension funds use to calculate liabilities. On Jun 13, Denmark raised the discount rate to a more normalized level of 4.2%, reflecting long-term inflation of 2% and growth of 2.2%. In the US, corporations are also asking Congress for a discount rate boost.

These initiatives allow pension funds and life insurers to make higher risk/return allocations, directly affecting equity markets because the demand for equities will rise. The impact might be substantial. Pensions and insurance companies manage about 28% of total financial assets in Western Europe, 37% in the US, and 26% worldwide, based on 2010 data from McKinsey Global Institute.

Generation Y

This generation usually refers to people born between 1979 and 1991. They have now entered the work force, are starting to save for retirement; they most likely have defined contribution pension plans, and therefore are making their own investment decisions. Because of their strong earnings power and long investment horizon, this age group is advised to hold more stocks than bonds. We often hear the impact of baby boomers, but the population of Generation Y is larger than baby boomers.

Developing countries

In the past decade, financial assets in developing countries grew 16.6% annually, nearly four times the rate in developed countries. Today the world's financial assets amount to nearly $200 trillion. 21% of them are held by investors in developing countries. This percentage is expected to reach 36% by 2020.

Most investors in emerging countries have very low allocations to equities. For example, Chinese households allocate only 14%, and Indian 8%, compared to US 42%, and Western Europe 29% (see the following chart).

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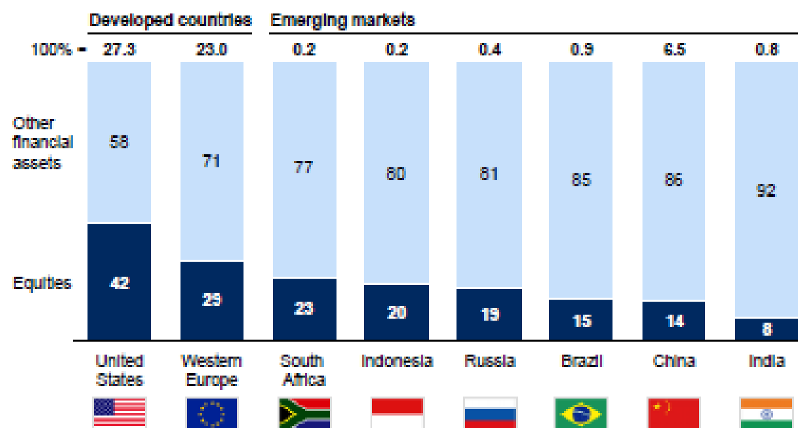

Pension and insurance industries are also underdeveloped in the emerging countries. For example, pension funds' financial assets accounted for only 9% of GDP in China in 2010, vs. 103% in the US. In January 2012, China Securities Regulatory Commission said it will "actively" push pension and housing funds to begin investing in capital markets, and encourage long-term investors such as insurers and corporate pension plans to buy more shares.

Not only domestic companies can benefit from the rapid wealth accumulation in developing countries, but also foreign companies. Three channels are possible.

1) Foreign companies can be listed in developing countries. It is already the case in India, and soon will be in China. In November 2011, the Shanghai Stock exchange said it's "basically ready" to let foreign issuers sell stock, with HSBC, Coca-Cola and NYSE Euronext among companies expressing interest.
2) Investors in developing countries can have access to overseas markets. Since 2006, China has allowed investment in overseas capital markets through products offered by Qualified Domestic Institutional Investors (QDIIs). Indian investors can invest abroad $200,000 per annum per individual.
3) Sovereign funds from developing countries invest actively worldwide. Their total financial assets were about $3.5 trillion in 2010.

In conclusion, the diversity of emerging participants in the stock markets should support healthy long-term growth.

Have a good weekend.

The Global Alpha Team

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