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Boomernomics Revisited

In 1995, I wrote a brief article for *Perspective* called Boomernomics: How Baby Boomer Savings Will Affect the Financial Markets. The basic idea was that one of the most powerful forces likely to affect financial markets over the next 10 to 20 years would be the aging of the baby boomers, who would need to invest in financial markets as they prepared for their retirement beginning in the second decade of this century.

My colleagues and I subsequently spent a great deal of time on research aimed at identifying sectors with especially promising growth prospects based not only on demographic trends but also on other major economic trends. Aside from demographics, we focused on the impact of the developing technology revolution and the ongoing process of globalization – forces we felt would remain important under almost any twists or turns of the business cycle or market environment.

In 1998, we expanded our articles on these themes into the book *Boomernomics*, which focused in some detail on the major themes of demographics, technology and globalization. The three key questions the book addressed were: (1) How the baby boom generation is transforming the economic and financial landscape; (2) How the financial environment is likely to be transformed by the forces of the technology revolution and globalization; and (3) How long-term investors could profit from an understanding of these forces.

In 1998, we launched CI Global Boomernomics® Fund, which was designed to benefit from the favourable growth prospects we identified in a number of key sectors, including health care, financial services, technology and telecommunications, and selected consumer products. The fund was also designed to have some exposure – initially about 25% – to fixed income, with the idea that fixed-income markets would benefit as inflation remained low and baby boomers competed with one another for reasonable returns on their retirement savings.

Can Optimism Survive a Bear Market?

The basic message of Boomernomics was optimistic: As baby boomers moved into their peak earnings and savings years, they would tend to push up the prices of financial assets as they saved for retirement, just as they had major economic effects earlier on other markets – like the market for real estate in the 1970s and 1980s, which was boosted as the boomers competed against each other as home buyers and renters of office space.

We were careful to argue that the forces we were describing were long term in nature, and that the decade to come would undoubtedly be marked by business cycle fluctuations, including the possibility of a challenging bear market or two. We argued that equity markets were likely to deliver returns in this decade closer to their long-term historical average of 10 to 12% instead of the 20% annual gains investors had become used to in recent years – and that even single-digit returns would not be surprising if inflation began to approach zero. Some of our strongest conclusions were that interest rates would fall to shockingly low levels and therefore equity valuation measures such as P/E ratios would stay surprisingly high compared to historical norms.

In the aftermath of the brutal bear market of 2000 and 2001 and the September terror attacks, optimistic long-term scenarios may seem hopelessly out of touch with today's realities. Accordingly, we thought it would be worth revisiting some of the major themes of the

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Boomernomics thesis, to take measure of what still makes sense and what ideas need to be adjusted or even scrapped altogether.

To start with our conclusion, we think there are still plenty of reasons to remain optimistic about long-term prospects for financial markets and about some of the sectors we identified in the Boomernomics book. However, some caveats apply, especially regarding the implications for government finances of the new war on terrorism. In a question-and-answer framework, we will try to address some of the key questions about the Boomernomics themes that we have received in recent months.

Q: How has the demographic outlook changed since you first wrote about Boomernomics?

A: Well, as predicted, most of us are six years older than we were in January 1996. So, looking out over the next 10 years, most boomers will be moving into their 50s and early 60s, with only the back end of the boomer generation (those born between 1962 and 1964) still moving into their early 40s (see Chart 1). The front end (those born between 1946 and 1951) will not be reaching the official retirement age of 65 until early next decade, although a significant number of early retirements will undoubtedly be taking place during this decade.

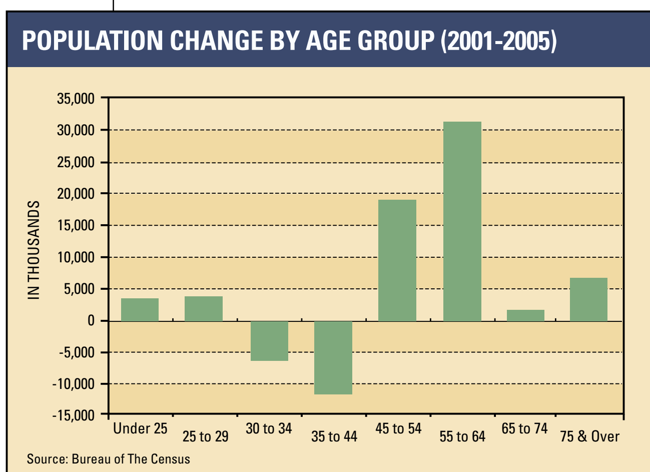

Chart 1. Changes in the U.S. population in this decade will be dominated by a surge in the number of those in their 50s and early 60s. A similar pattern will be seen in Canada.

Still, the median baby boomer has well over a decade to go before hitting retirement age. Since the boomers are still far more numerous than the preceding generation or the following "baby bust" cohort, that means they are likely to create a wave of demand for products typically used by those in their advanced middle years. This list still includes financial services, health care and selected consumer goods and services like leisure, entertainment and travel. Assuming that the terror issue does not become a decade-long horror show, we think there are opportunities in these areas now, despite the current recession and related worries about consumer spending.

We still believe strongly that investors should pay close attention to demographics, because demographic trends remain far more predictable than most other economic forces. And we still believe that it is no accident that maturing societies tend to favour policies that support low inflation and interest rates – a correlation seen in Chart 2 – since older workers do not wish to see the value of their retirement savings inflated away by reckless government spending.

It is interesting to see this inherent conservatism manifest itself in the recent difficulties the U.S. administration has had in getting Congress to pass a big economic stimulus package. Once the war in Afghanistan seemed headed towards a speedy conclusion, congressional support for the budget-busting spending and tax-cutting proposals began to waver.

Q: What about the outlook for technology and telecommunications in light of those industries' current woes?

A: Although we became cautious about those sectors in early 2000 in the wake of the Y2K boom, we fault ourselves for not anticipating the full extent of the bust in 2001. It is now conventional wisdom to assume that those sectors will be relatively slow to recover, reflecting extremely competitive conditions created by a great deal of investment in capacity during the boom in recent years. The good news, however, is that conditions in these industries finally appear to be stabilizing as the global economy seems to be responding to the positive forces of monetary easing and lower oil prices.

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We think much of the vehemence of the downturn in tech and telecom had to do with the "double whammy" effect of a normal business cycle downturn combined with the distortions created by the Y2K computer bug investment boom/bust dynamic. Since we will soon be more than two years past the Y2K distortion and since business cycle dynamics should soon turn more positive, we would not be surprised to see the underlying demand outlook be revised upward again.

We have also been encouraged that U.S. productivity performance during this downturn has been one of the best on record. That means that recent technology and telecommunications investment really does seem to be increasing the economy's long-term growth potential and that businesses are likely to continue to have strong incentives to invest in labour-saving technology once current financial conditions ease.

This also suggests support for one of our long-term themes from *Boomernomics*, which ties together demographics and the technology revolution. With workforce growth expected to slow in the U.S. and other major industrialized nations in this decade, labour will become relatively scarce. However, with baby boomers saving for retirement and with technological change still occurring at a rapid pace, businesses will have strong incentives to substitute cheap (and relatively abundant) capital for expensive (and relatively scarce) labour, which implies a continued investment-led dynamic in the global economy.

AGE WAVE

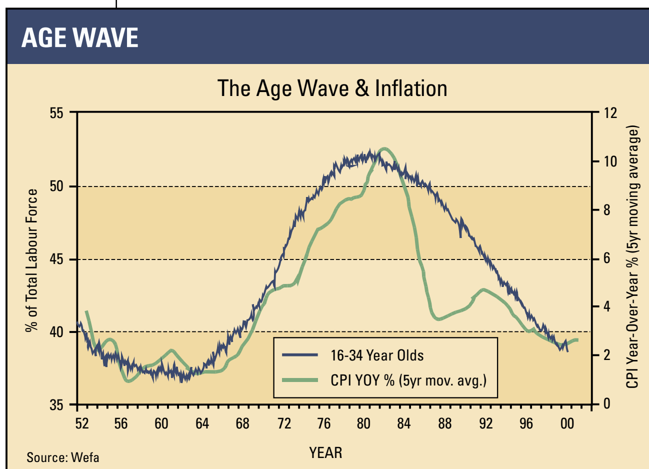

Chart 2. Historically, an older work force has coincided with lower inflation.

Q: Is globalization passé in view of recent international disturbances?

A: That is a pretty tough question, since we have recently experienced the downside of globalization – even terrorists are now capable of creating organizations with global reach.

It is certainly far easier to be optimistic on this topic now than it was in the immediate wake of September 11. Most countries that were asked to "choose sides" opted almost immediately to support the community of nations, led by the United States, that opposes terrorism and favours a free and open global economy.

Likewise, dire predictions of the war on terrorism turning into a Vietnam-style quagmire and of massive destabilization of other governments in the Islamic world have so far proved to be off base – especially as it quickly became clear that many long-suffering Afghanis were more than happy to hook up televisions and reject the extremists among them. Once again, it seems that governments and economic systems based on the pursuit of life, liberty and the pursuit of happiness seem to have widespread appeal – especially considering the alternatives.

However, it is also clear that the war on terrorism is far from over. A new and potentially more dangerous chapter could lie ahead if America attacks Iraq or if terrorist cells unleash new horrors on U.S. soil. Might new and devastating attacks cause America to turn its back on global alliances, undermining support for globalization? We doubt it, but cannot deny that important threats to the current geopolitical framework for globalization have emerged.

Q: Does the recent poor performance of growth investing and growth-oriented funds like yours suggest that the Boomernomics thesis is fatally flawed?

A: In Boomernomics, we argued that investing is always about making tradeoffs between prospective growth and what you have to pay for it –

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about balancing growth versus value. That means that if you overestimate a company's growth prospects, you may overestimate what its stock is worth. Conversely, if you underestimate a company's potential growth, you may underestimate what its stock is worth.

Historically, in many markets, the swings of fortune between "growth" and "value" stocks have been almost as difficult to predict as predicting the overall market. In other words, for long periods of time the market may favour companies with relatively rich valuations and attractive long-term prospects. Then, it may switch gears and favour those with cheap valuations, even if their long-term prospects are materially less attractive.

The market has seen an extraordinary degree of volatility between growth and value styles in the last few years, with growth-oriented styles trouncing value styles in the late 1990s and the reverse being the case more recently (see Chart 3).

Our view is that with growth stocks having been hit hard and value stocks having been revalued, fund investors may be wise to employ a bit of "style agnosticism" in their fund selection by diversifying by investment style. As always in this business, there is no guarantee that last year's winners will be winners this year or that last year's losers will continue to underperform.

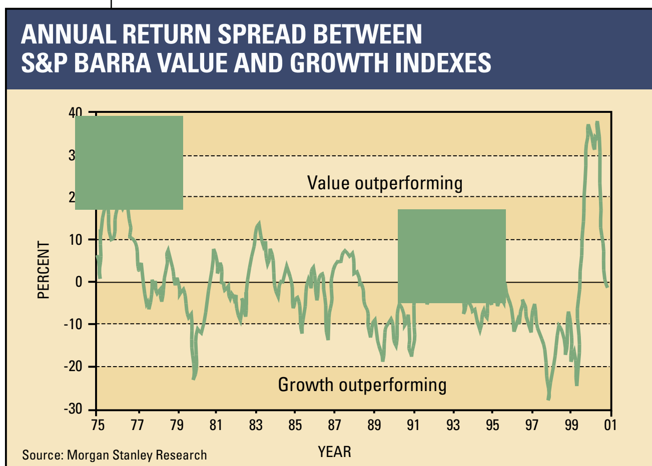

Chart 3. Value stocks have outperformed growth stocks during the global slowdown, but it is doubtful that one investment style will dominate indefinitely. For investors, diversification across styles remains prudent.

If we are correct, and the global economy recovers and moves back into a low-inflation, high-productivity trajectory, our growth-oriented investment themes should do well.

Q: Is 25,000 on the Dow Jones Industrial Average still in the cards for the end of this decade?

A: As we wrote in Boomernomics, a mantra for such questions is "NO-BAH-DEE-NOZE." But we can provide some perspective.

To double in price in seven years, the Dow needs to appreciate at a 10% compound rate over the period. That would not be out of line with long-term historical precedents, and would put the Dow on target to hit 25,000 by the end of 2010. That said, in view of how low interest rates have already fallen, a more conservative projection would look for equity returns of around 8% per annum or about 3% over the current yield of 10-year U.S. Treasury bonds. That would put the Dow on track to hit 25,000 in about 2012.

While such numbers may sound low relative to the supercharged expectations from the 1990s, the reality is that they would not be bad in an environment where inflation is about 1% to 2%. And that is the kind of environment we think we are moving into. Moreover, compared to what "risk free" money market funds may return – which is currently less than the rate of inflation – we think investors will continue to have little choice but to make a commitment to equity markets an important part of their financial planning.

Bear markets force investors and companies alike to temper their expectations for the future. But we believe it is as mistaken to be "irrationally despondent" following a bear market decline as it is to be "irrationally exuberant" during a runaway bull market. And we still don't know too many rich pessimists.

Please accept our best wishes for a happy and far more prosperous new year.

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