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Boomernomics: Past, Present and Future

In the mid-1990s, we began research into the investment implications of long-term changes in demographics, technology and globalization. We called this research Boomernomics and published a book with that title in 1998. We also launched CI Global Boomernomics® Fund that year

based on those investment themes – just ahead of what has proven to be one of the most tumultuous investment periods in decades.

Our intent in undertaking thematic investment research and investing accordingly is to

take a long-term view of investment risks and opportunities. One of our core beliefs is that this approach can add value in an investment environment that is constantly buffeted by short-term news stories and rapid changes in sentiment.

Looking Back

With five years, several wars, and a major bear market now apparently behind us, it is worth looking back to consider how we have done, where we have been right and wrong, and how we think the long-term outlook has changed.

For virtually anyone investing in equities, the last few years have been a trial. On a year-by-year basis, CI Global Boomernomics® Fund has outperformed the MSCI World Index four out of the five calendar years since its

inception, and has outperformed in 2003 for the year-to-date. That said, the fund underperformed significantly in 2001 (See Table 1).

We are obviously disappointed in our absolute performance during this period, as we know our clients have been. However, in view of our long-term commitment to equities as an asset class, we take some solace in having outperformed the index over the period and during most (but not all) sub-periods.

Looking back at what has worked and what has not worked over the past five years, we would first highlight the following positives:

First, the Boomernomics sector mix of consumer discretionary, financial services, health care, technology, telecommunications, and a strategic commitment to bonds has outperformed the index by about 10% since

CI GLOBAL BOOMERNOMICS® FUND VS MSCI WORLD INDEX

	PERFORMANCE (C\$)					
	2003*	2002	2001	2000	1999	1998†
CI GLOBAL BOOMERNOMICS® FUND	+5.4	-20.0	-26.8	+5.8	+42.8	+18.6
MSCI WORLD INDEX	+1.3	-22.0	-12.7	-11.0	+16.2	+11.1

Data as of 08/31/03, Canadian dollar (Libor exchange rate), Net of fees, Index information is Price data, †Inception date 06/30/98 *Year-to-date

Table 1: CI Global Boomernomics® Fund outperformed the MSCI World equity index four out of five calendar years from inception but lagged significantly in 2001.



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mid-1998. That's largely because the bond holdings helped to offset the negative performance and high volatility associated with technology and telecommunications during this period.

Second, our defensive positions in 2000 and 2002 helped us outperform the equity index in both of those years. Unfortunately, we were not as defensive as we should have been in 2001.

Looking back at what hasn't worked well over the past five years, we would highlight the following negatives:

First, our stock selection in 2001 – especially in the technology area – was weak, as growth stocks took a drubbing.

Second, and closely related to the first point, our valuation framework relied too heavily on discounted cash flow analysis prior to September 2001. In practice, that meant that it was too dependent on earnings forecasts that turned out to be overly optimistic.

Third, our emphasis on growth-oriented equities was a plus during the bull market years, but a minus during the bear market when value stocks posted the best relative performance.

How have we adapted our investment process based on the lessons of the last few years?

First, we added veteran growth stock investor Bob Beckwitt (formerly of Fidelity and Goldman Sachs Asset Management) as co-portfolio manager in September 2001 and substantially broadened our valuation discipline under his leadership. We still look at discounted cash flow analysis, but we also spend more time looking at a broad range of valuation metrics relative to their own history to help us judge when earnings forecasts are overly optimistic or overly pessimistic.

Second, we strengthened our company research capability in 2002 with the addition of several talented new analysts, including Greg Gigliotti and Lara Alden. This came against a backdrop where sector valuation discrepancies became less pronounced as the bear market progressed, putting a greater premium on stock picking as a means of enhancing returns.

Third, we broadened our use of bonds beginning in 2001 to include foreign bonds, inflation-protected bonds and high-yield bonds. This came in response to declining government bond yields and worsening

government finances, both of which suggested that more opportunities in fixed income would be away from traditional government bonds.

In our research from the mid-1990s, our strongest conclusion was that interest rates would fall to shockingly low levels as inflation stayed low amid intense global competition and technology-driven productivity improvements. We were also correct to anticipate that this would keep price/earnings ratios substantially higher than historic norms, although we did not anticipate the degree of compression of P/E ratios that occurred during the bear market.

And while our research never called for the end of business cycles or bear markets, we did not anticipate the severity of either the profit declines or geopolitical shocks that we saw in the last several years.

Looking Ahead

Where do we stand now? As we explained in last month's *World Report* (available online at www.cifunds.com), we think investors will be surprised by the strength of the profits recovery in coming quarters and we remain constructive on the outlook for equities.



Boomernomics: Past, Present and Future *(cont'd)*

We continue to believe that inflation and interest rates should remain low this decade, but likewise think that we have already seen the cyclical low in rates in June of this year. As we explained in the July *World Report*, we likewise think fears that the U.S. will fall into a Japan-like deflation are overdone. And at this point, only a deflation/depression forecast would justify an aggressive commitment to bonds.

Accordingly, we are no longer secular bond bulls and believe that equities should outperform bonds substantially in coming years. This view is based on both relative valuation work and changing fundamentals that we will touch on shortly.

When asked what has changed on a secular basis since the mid-1990s, we would highlight the following points:

First, the baby boomers are older and have fewer years to save before the retirement wave begins. Remember, the first boomers were born in 1946 and begin to turn 65 en masse in 2011.

Second, consumer debt has risen and the pressure to increase savings and improve balance sheets has numerous implications. The emphasis on savings suggests the need for greater selectivity in consumer-oriented investments in coming years. Also, the high degree of leverage in the economy may dampen interest rate cycles, making the U.S. Federal Reserve likely to tread gingerly when it next decides to raise rates.

Third, the severity of the recent stock market slump may have increased the structural demand for fixed-income investments, as many aging investors move toward more

conservative asset allocations despite frustratingly low rates of return. That may also tend to dampen the degree to which bond yields rise as the economy recovers – which paradoxically should support higher P/E ratios.

Finally, the world clearly has become a scarier place. That has negative implications for government budgets and argues against further secular advances in government bond prices.

When asked what hasn't changed on a secular basis since the mid-1990s, we would highlight the following points:

First, the process of globalization continues to create intense competitive pressures that should help keep inflation low throughout the developed world. Even though we think fears of deflation are overdone, the remarkable rise of countries like China and India is of major importance in reducing inflation pressure elsewhere in the world.

Second, the pace of technological change continues to accelerate, despite the stock market gyrations associated with the "Tech Wreck."

DEMOGRAPHIC "LONGS" – FAVOURED AREAS

LEISURE & RETIREMENT SPENDING

- Vacation Homes
- Recreational Vehicles
- Resorts and Cruises

HEALTH SERVICES

- Medical Equipment/Lab Tests
- Senior Housing and Care
- Hearing Aids

ECHO BOOMER SPENDING

- College-related expenses
- Low-end real estate

Table 2: Goods and services that cater to aging baby boomers and echo boomers should benefit from positive demographics over the next five years.



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Third, productivity gains remain impressive despite the slowdown in investment over the last several years. That should support higher growth rates and improved margins as the global economy improves.

Finally, related to the above factors, businesses still need to aggressively substitute cheap technology for expensive labour, suggesting that an investment-led growth pattern will resume.

In short, the conditions fostering an economic climate characterized by low inflation and high productivity remain in place, despite the business cycle and geopolitical disturbances of the last several years. If we are correct, and profit growth proves to be surprisingly buoyant over the next year or so, the stage is set for equities to outperform fixed income substantially.

DEMOGRAPHIC "SHORTS" – AREAS FACING CHALLENGES

KIDS STUFF

- Day-Care Centres
- Children's Clothing
- Playground Equipment/Toys
- Bicycles

THIRTY-SOMETHING SPENDING

- Beer and Ale
- Winter Sports Equipment
- Admission to Sporting Events
- Moving and Storage
- Mortgage origination

Table 3: Goods and services that cater to groups other than baby boomers and echo boomers are likely to face challenges over the next five years.

Our sector work also continues to emphasize companies that will benefit from favourable demographic trends, especially the aging of the baby boomers and the rise of the "echo boomers" (the boomers' children). Over the last few months, we used detailed age-based consumption survey data from the U.S. Bureau of Labor Statistics to identify what goods and services will have the most favourable and least favourable demographic backdrop over the next five years. Our method was to first measure which age groups would grow the most or contract the most from 2003 through 2007 and then look at which products were best positioned or worst positioned for that demographic profile. Some of our key results are summarized in Tables 2 and 3. We plan to elaborate on some of these themes in future editions of *World Report*.

Goodbye to Disinflation?

One final point: If we are correct and the world has entered a period of steady low inflation, that has a number of important implications. Most importantly, it implies that the period of disinflation is over. Disinflation meant that inflation rates around the world, beginning in the early 1980s, tended to drop year after year. That created a secular decline

in interest rates that triggered massive windfall capital gains for bond investors year after year.

The secular decline in bond yields contributed to supercharged gains in equity markets as well, with much of the gain in equities coming from higher and higher P/E ratios – which were the counterpart to the windfall capital gains experienced by bond holders.

In a world of stable and low inflation, all of that changes. If inflation and interest rates fluctuate around a low level, bond investors basically will earn their coupon – period. No more windfall capital gains! Stock price gains will depend more on earnings growth rather than P/E ratio expansion.

Against that backdrop, pressure on investment managers to outperform both their investment benchmarks and their competitors is likely to become especially intense. We firmly believe that a thematic approach to investing, as we have developed in our Boomernomics research, will be able to generate a competitive edge for our clients in this environment.

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