Voice

Viewpoint: Global Economic Shift Offers Investment Opportunities

by David Hansen

David Hansen is founding partner and managing director of Meridian Wealth Management, an independent, full-service investment advisory firm based in Boulder, Colorado. He is a registered principal with, and securities are offered through, LPL Financial, member FINRA/SIPC. David can be reached at (888) 209-7092 or david.hansen@lpl.com.

I accompanied my two teenage daughters to the mall recently for some clothes shopping. While they might prefer to take the credit card and leave me at home, I join them occasionally to make sure they can still distinguish the difference between wants and needs. If your family is blessed with significant discretionary income, you know that lectures on thrift have an impact that evaporates once your teenagers enter a clothing store. My admonitions are no match for designer marketing savvy.

Of course, lacking discretionary income, discussions about wants versus needs would be pointless, since there would be no money for anything but needs. But the availability of money for non-necessities is assumed in most American families and has been for decades. I wondered how parents in countries with emerging economies are dealing with their newfound discretionary income. Are children of middle class families in Russia, China, India, Brazil, and the Middle East now getting wants-versus-needs lectures from their parents before they head off to newly constructed malls?

The burgeoning global middle class is generating historic economic and financial changes. I believe these changes may provide one of the most significant investment opportunities of the past half-century. Consider that hundreds of millions of people around the world suddenly have something they have never had before: discretionary income. There are now an estimated 100 to 150 million middle class Chinese alone.[1] We've seen the behavioral changes of Americans as their discretionary income increases. Now imagine the magnitude of the behavioral transformation as billions of people in Brazil, Russia, India, and China—the BRIC countries—suddenly have more money than they need to subsist. These people now have choices unparalleled in their history: choices in food, clothing, durable goods, transportation, even luxury purchases.

As people become more affluent, protein consumption goes up. Gold tends to benefit because jewelry is how people in many cultures display wealth and position. Methods of transportation change as people move from walking to bicycles to motor scooters to subcompact cars to larger Western-style cars. And those are just a few of the changes that occur as emerging middle-class citizenries move up their respective economic ladders. Countries whose combined populations dwarf that of the United States are experiencing unprecedented growth, prosperity, and economic clout.

An almost unimaginable amount of money will be spent in new places and all this spending will stimulate new markets and new investment opportunities. If you believe that "demographics are destiny," we are witnessing an unprecedented historical event. It's a decoupling of the traditional relationship between developed and emerging economies, a rebalancing of global economics that portends a shift away from U.S.-dominated growth toward more dispersed expansion, supported by numerous developing economies. The pace of change will differ among the various countries, and while those with the strongest growth will doubtless provide some of the best investment opportunities, growth alone doesn't translate into asset appreciation.

> "The burgeoning global middle class is generating historic economic and financial changes."

Uncharted Waters

The world is going to look a lot different in 10 or 20 years. While some like to believe the tendency of the global economy to revolve around the United States will continue, the scale and speed of the current economic decoupling tells us we are entering a new global environment, one that has already undergone a dramatic shift. There is considerable speculation among the investment community as to exactly what this shift forecasts, but one thing is certain: we are entering uncharted waters.

The BRIC countries continue to grow annually at high single or low double digits, while the U.S. economy has slowed to between 0 and 2 percent. It's just a matter of time before the economic decoupling (lower correlation to U.S. growth) converts to financial market decoupling (how international bond and equity markets react to movements in U.S. markets). One implication of this is that when the United States sneezes, the rest of the world will no longer necessarily catch cold. And while some investors may cling to a fear of foreign market volatility, it's volatility that creates opportunity.

Aldous Huxley said, "Facts do not cease to exist because they are ignored."[2] The fact is there are millions of highly educated, hard-working people in this world willing to work for a lot less money than Americans. Given comparable quality, if a product's labor cost in one country is a fraction of the cost in another country, businesses will migrate to the lower-cost alternative. They have an obligation to their shareholders to do so. The fact is, that is what's happening and there is nothing to suggest it will not continue for at least the time being.

From 1996 to 2006, the United States steadily maintained about 20 percent of the world's Gross Domestic Product. During the same period, the BRIC countries' share of GDP soared from 18 percent to 26 percent, moving toward a more proportionate share based on population. Once again, it's the ageless story of supply and demand: those offering quality at a lower price tend to dominate the market.

Bill Donohue, an executive at Ivy Funds, uses a baseball analogy to help explain what's happening. "It's common knowledge among baseball fans that Branch Rickey was responsible for integrating major league baseball by signing Jackie Robinson for the Dodgers. However, not many people realize Rickey also brought the first foreign-born player into the major leagues, Roberto Clemente. Once Rickey opened the spigot, it triggered a flood as baseball scouts began making trips to Latin America looking for talent. Later, the scouts added Japan to their international itinerary after Ichiro Suzuki became the toast of Seattle. Ask kids who their favorite baseball player is today and there's a good chance he was born in another country. Well, the same thing has happened with capitalism. In the past, the U.S. was in charge of the game, dictating the rules and who played. But we represent just 5 percent of the world's population; every once in a while, somebody else learns to play the game better than we do and we are forced to change. Right now, investors might be wise to follow the lead of the baseball scouts and look overseas."

Asset Allocation Conundrum

As access to and information about foreign markets increases, the argument for investing internationally has changed from "whether or not" to "how and how much."

Of course, defining whether a company is domestic or international has become increasingly complicated. Toyota and Honda have stateside manufacturing facilities that employ tens of thousands of Americans. On the other hand, some of the largest companies in the S&P 500 now generate the majority of their revenues overseas. The lines between domestic markets and global markets have blurred to the point where they've virtually disappeared. All this can be disorienting for investors because so much has changed.

Adding emerging markets to a client's portfolio traditionally involved high risk and volatility as a trade-off for potential high returns. Modern portfolio theory would deem the strategy inappropriate for clients approaching or in retirement. Many columnists and financial pundits continue to recommend no more than 5 percent of one's portfolio be linked to international issues, but I question whether that provides adequate diversification for most portfolios. And the introduction of global diversity does not have to include "emerging" markets. There are numerous alternatives for incorporating international issues for volatility-averse investors.

Determining an appropriate international percentage is obviously something to be done on an individual portfolio basis.

Corrections

Correction to Quote

In "Joker in the Deck: Flexible Estate Planning in the Face of Changing Tax Laws…and Client Lives (Richard F. Stolz, June 2008), Jean Bedell was incorrectly quoted. Her quote is printed as "if assets aren't structured properly, they can waste the estate, because they will only control the assets that are in the individual's name."

The quote instead should be "if assets aren't structured properly, the [estate] exemption can be wasted, because the will only controls the assets that are in the individual's name."

Correction to Table

In "Thinking About a Roth 401(k)? Think Again" (Edward F. McQuarrie, Ph.D., July 2008), a reader pointed out an error in the sidebar titled "Comparison of Roth with Regular 401(k) Accounts."

Correction: Money left in a Roth 401k account is subject to the same required minimum distribution rules at age 70½ as a regular 401(k) account. A rollover to a Roth IRA, which can be done without tax consequence, is required if RMDs are to be avoided on Roth 401(k) funds (see IRS publication 4530 and the Federal Register, Vol. 71, no. 1, page 8).

Given the muddled distinction between a domestic and international company, the task gains complexity. Some believe currency is the answer, that clients should have a percentage of assets in U.S. dollars equal to their percentage of debt in U.S. dollars. That rudimentary approach makes no sense to me because typically it translates into 100 percent since most domestic portfolios don't owe any money to the bank of China or Brazil. Even when clients seek to diversify with international equities, it's not so easy. Is Pepsi a U.S. or an international stock? With about half their revenues in currencies other than the U.S. dollar, it's a tough call. Things have gotten jumbled and many conventional demarcations are no longer very useful.

One of the things I try to emphasize with clients is that we are not necessarily trying to accumulate the most number of dollars; we're trying to enhance and protect their ability to acquire future goods and services. Given inflation, market risk, overconcentration, and other factors, one way to increase the likelihood of being able to acquire future goods and services is to diversify their portfolios. This means paying attention to currency diversification similar to the attention given to stocks and bonds, sector allocation, and the like. It's self-defeating to have a portfolio successfully accumulating dollars if the dollar is diminishing in terms of its purchasing power. Having a market basket of currencies can be one leg of a strategy to add international exposure while helping preserve purchase capability.

Investors who fail to recognize the economic and financial market decoupling that is occurring may miss an important opportunity. Markets tend to come full cycle. In the 1970s, it was commodities; in the 1980s, foreign investments, primarily Japan; back to the United States again in the 1990s; and in this decade, commodities again. I believe that in the coming decade it will be foreign investments again. Success comes from staying ahead of the curve and, like the baseball scouts, knowing where to look for the next generation of all-stars.

Advisors who want to take advantage of the emerging global middle class and its growing impact on the markets might want to assess the level of international diversification of their client portfolios. It's better for clients to make their decisions based on an informed advisory relationship than TV talking heads.

JFP

Endnotes

1. "Gilded Age, Gilded Cage," *National Geographic*, May 2008.
2. *Proper Studies*, 1927.