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The Active Approach to Investing in International Demographic Trends

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Analyzing a country's demographics can be a powerful forecasting tool when investing internationally. Demographic research can reveal structural changes in a population and present compelling reasons to invest in countries that appear primed for economic improvement. It can also help investors know which countries to possibly avoid, like those with aging populations or declining wage growth.

In this research, we discuss demographic patterns related to income levels in non-U.S. countries, which help provide a blueprint for interpreting industry-specific investment potential. We also explain why an active approach to security selection may be a compelling approach to achieving favorable returns when investing in demographic trends.

Historical mapping: a blueprint for investing

To assess where new demographic-driven growth patterns may occur, we studied five countries whose economic trajectory had progressed to developed-market GDP-per-capita levels. We then analyzed the economic development of each country and divided them into various thresholds of per-capita gross domestic product (GDP)—a measure that takes the GDP of a nation and divides it by the number of people in the country.

This analysis led to five distinct groups, with GDP per-capita levels ranging from $25K down to $3K. We then evaluated which consumption-driven economic segments had the fastest growth at particular wealth levels. What we learned is that specific consumption trends were repeated across different markets as their economies passed various economic milestones. Exhibit 1 (below) shows the fastest-growing industry segments at each per-capita threshold in our study—a potential blueprint for investing.

EXHIBIT 1: Historical mapping can help uncover structural growth trends in developing economies and can be a blueprint for investing.

PER-CAPITA THRESHOLDS	FASTEST-GROWING INDUSTRIES	COUNTRIES IN THRESHOLD TODAY
$19K–$25K	Insurance, Nursing Homes, Education, Life Insurance, Water Supply/Sanitation, Telecom	Hungary, Poland, Israel, South Korea
$14K–$19K	Water Supply/Sanitation, Education, Housing, Personal Care	Turkey, Mexico, Malaysia, Chile, Russia, Argentina
$9K–$14K	Insurance, Nursing Homes, Dental Services, Water Supply/Sanitation, Housing, Education	China, Thailand, Peru, Columbia, South Africa, Brazil
$6K–$9K	Water Supply/Sanitation, Accommodations	Egypt, Ukraine
$3K–$6K	Media, Processing Equipment, Telecom Services, Nursing Homes, Motor Vehicles, Insurance	Nigeria, India, Vietnam, Philippines, Indonesia

**Per-capita thresholds are measured on a Purchasing Power Parity (PPP) basis, which considers inflation and currency differential effects on different countries historically. Source: Fidelity Investments, as of Sep. 30, 2014.*

ACTION STEPS

- When considering international investments, demographic and industry analysis can provide helpful clues about the potential attractiveness of a particular country or region.
- The benefit of active management approach is that it has the potential to pinpoint specific investment opportunities with the highest likelihood of yielding strong investment results. Fidelity has the size, scale, and global research capabilities to access information across the world to identify these investment opportunities.
- Investors should be aware that some demographic analysis techniques, such as historical mapping, may provide a virtual blueprint for investing.

For more detailed analysis, see the full-length Leadership Series article, "The Active Approach to Demographic and Industry Analysis in Non-U.S. Investing" (Dec. 2014).

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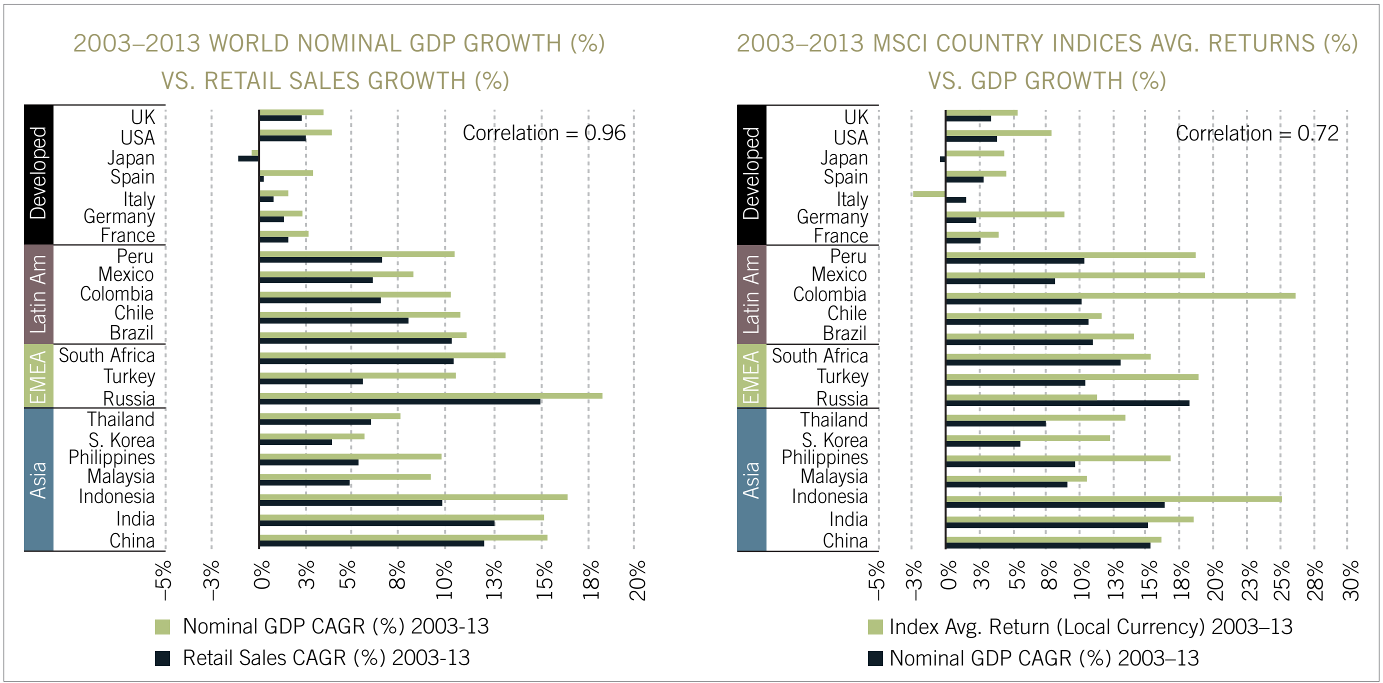
EXHIBIT 2: Strong GDP growth has historically been highly correlated with retail sales growth, but there is typically a lower correlation between GDP growth and stock market performance.



Past performance is no guarantee of future results. CAGR = compound annual growth rate. Source: Euromonitor International, FactSet, through Dec. 31, 2013.

Here are some other highlights of our findings:

- Water supply, waste disposal (sanitation), and education drew a disproportionate share of consumer spending at per-capita GDP levels above $6,000.
- Health care, insurance, and telecom—which have historically enjoyed the status of "superior goods"—also captured a larger share of incremental consumer spending as incomes grew.
- On a relative basis and in general, food, clothing, footwear, and other so-called "inferior goods" captured fewer incremental dollars at most per-capita levels. However, these market segments can occasionally provide superior returns given an advantageous industry structure.

In essence, Exhibit 1 shows why it may be a good idea to avoid investing across all sectors, and to instead focus on industries where growth is superior and may be underestimated. That's the power of using a historical study. It can pinpoint when certain industries grew most rapidly and when growth rates slowed. Additionally, knowing the historical magnitude and time horizon for growth may contribute to more-accurate growth forecasting.

Specific demographic examples

GDP growth and retail sales = high correlation

Historically, there's been a strong correlation between a country's GDP growth and its retail sales growth. In other words, countries with the fastest-growing economies generally have the fastest retail sales growth. In the 2003 to 2013 period we studied, the correlation score between GDP growth and retail sales was 0.96, just shy of the perfect correlation score of 1.0. During that 10-year period, Russia had higher levels of GDP and retail sales growth than any other country (see Exhibit 2 left, above). China and India also were among the fastest growers. Generally, economies that showed significant improvement in their per-capita GDP were the best investment opportunities. Conversely, countries with weak economic growth tended to have the weakest retail growth (such as Japan).

GDP growth and equity returns = weaker correlation

Though it may seem counterintuitive, GDP growth and stock market performance in a country are not as correlated; for the 10 years ending 2013, the correlation was 0.72 (see Exhibit 2 right, above). Dichotomies like this can occur when the equity market composition of fast-growing countries does not reflect domestic trends. Some stock and/or country-specific issues may even conflict with positive demographic trends. Thus, a more granular approach to demographics may unearth better investment opportunities than basing investing decisions on a country's GDP growth alone.

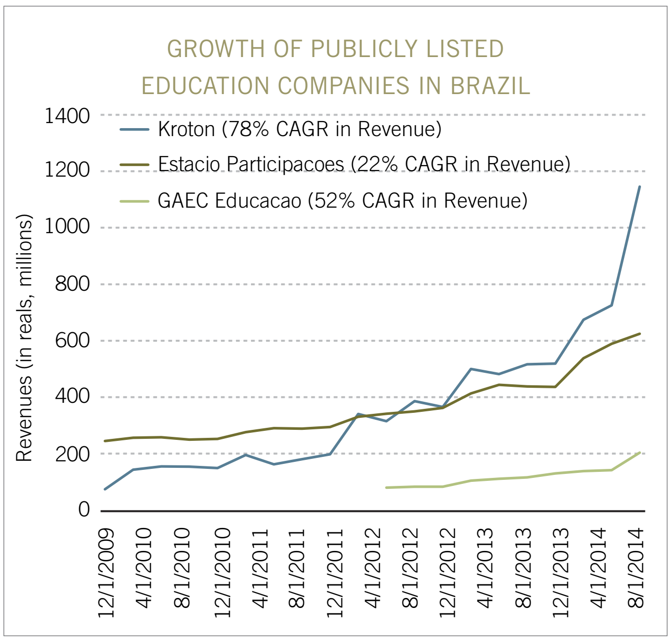
Demographic case studies

Demographics alone do not fully inform an investment decision; it's better to complement such research with an evaluation of company-, industry-, and country-specific factors. The following case studies show how these different forms of analysis work hand in hand to form a more comprehensive picture of potential opportunities.

Case study 1:
Investing in education in Brazil
Historically, education is a fast-growing market segment among economies in the top three GDP brackets. As countries grow in wealth, the focus on education—and the dollars spent—increases. Consider Brazil, for instance. Its current GDP places Brazil in the $9K to $14K bracket of our historical mapping study (refer back to Exhibit 1, page 1). At this level, education historically becomes one of the fastest-growing industries. Outside of government universities and private religious institutions, the post-secondary education system in Brazil is largely led by for-profit colleges and university companies. At present, their growth rates are very high, consolidation is occurring, and the government has enacted supportive policies to help students attend higher-education classes in many important fields, such as health care.

The recent growth of Brazil's education industry is demonstrated in Exhibit 3 (below), which shows the five-year revenue increase

EXHIBIT 3: Government policies can help make or break an investment opportunity.



Source: Bloomberg Finance L.P., Fidelity Investments, as of Sep. 30, 2014. References to specific investment themes are for illustrative purposes only and should not be construed as recommendations or investment advice. Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

for the country's largest publicly listed education companies. While this trend alone is compelling, remember the importance of considering more than one variable when investing in a growth trend. For example, there are 2,300 institutions in Brazil; Kroton, one of the largest publicly listed education companies, is targeting 645 of those institutions for acquisition to help consolidate the industry.[1] Brazil's government put in place favorable lending terms for student loans and favorable tax rates for education companies, but that policy is always subject to change. So investors need to follow government factors as well industry dynamics in this fast growth industry.

Case study 2:
From local to global—competitive dynamics in India
As shown in our mapping study, the motor vehicle industry becomes a fast-growth segment of the market when GDP per capita reaches the $3K to 6K level. That's where India finds itself today, and it provides a good example of how competition in a growth industry must be evaluated. From 2005 to 2009, the market share among Indian automobile manufacturers was dominated by only two players, Maruti Udyog and Tata Motors. But then the Indian government supported the entrance of such global companies as Volkswagen and Toyota, which completely changed the competitive dynamics. This doesn't mean an investment opportunity no longer exists; the auto industry should still offer strong growth based on demand. But the industry dynamics now merit additional research (e.g., whether the product lines are suited to the population's taste, distribution networks, operational abilities, etc.) in conjunction with the population's wealth profile in order to uncover growth potential.

Potential benefits of active management

Trying to tap into a compelling demographic trend via passive strategies can leave investors stuck with companies that may have little or no exposure to that trend. Conversely, experienced active equity managers backed by skilled research analysts and traders can take a more targeted approach. Part of that involves exploring and pinpointing specific investment opportunities with the highest likelihood of yielding strong investment results. Fidelity's historical mapping exercise is followed by a detailed analysis of the emerging patterns on a country-by-country basis, which includes studying history and other salient industry and country fundamentals that make an investment in a strong growth area a success or failure over time. The result of this work is a blueprint that can serve as a guide to help inform an active manager's decision making about demographic-driven opportunities in non-U.S. equity markets. Therefore, we believe adopting an active style for investment security selection can be a compelling approach to achieving favorable returns when investing in demographic trends.

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Endnote

[1] Kroton Educacional SA.

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