Bound for Growth:

The Emerging Middle Class is on the Rise and Ready to Spend

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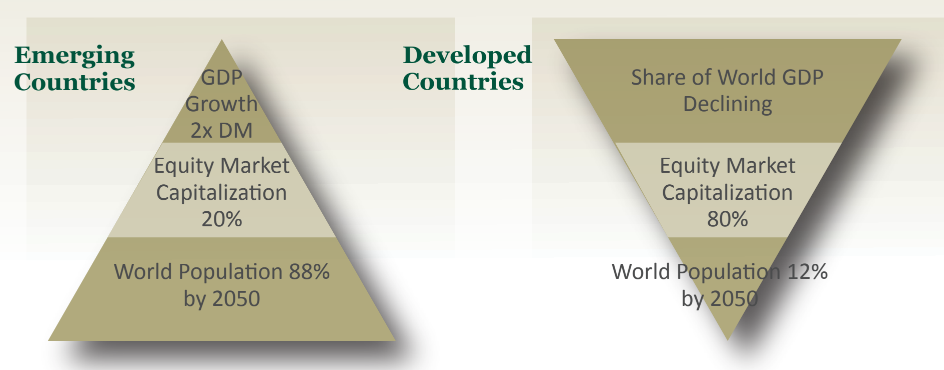
The worldwide economic picture may be full of uncertainties but one thing seems likely: the demand for goods and services in the developing world will grow at an unprecedented rate as the emerging middle class[1] rapidly expands over the next couple of decades. Currently, 70 percent of the global population resides in the developing world, where demographic changes, growth in wealth and income and exports are helping to propel people into the middle class at an unparalleled rate.

The world is undergoing a seismic shift as developing countries become the engines driving global economic growth. According to Credit Suisse's Global Investment Yearbook for 2010, emerging markets currently make up 31 percent of the world's GDP, and the GDP of those economies is rising at twice the rate of the developed world. Much of this growth is happening thanks to the developing world's burgeoning middle class, which by the middle of the century is expected to exceed the combined total populations of Europe, Japan and the United States.

Compared to the developed world, economic trends throughout emerging markets are on the upswing. Overall, the government credit profiles in the emerging world are improving and their populations are young and urbanized with growing amounts of disposable income and unmet consumer needs. In contrast, the government credit profiles in the developed world are getting worse, the populations are aging, the consumer industries, including housing, are overdeveloped and the people in these countries are saving rather than spending.

In the years ahead these demographic shifts will drive revenue growth in a range of industries, from consumer goods to banking to construction. Much of this growth will come from the largest developing countries, Brazil, Russia, India and China, where the middle class is expected to double in the next 10 years, according to Goldman Sachs. However, even smaller developing countries are expected to see their middle class populations swell. **Worldwide the middle class is gaining 70 million new members annually, which will translate into two and a half billion emerging middle class consumers over the next 10 years.**[1]

FIGURE 1. EMERGING COUNTRIES VERSUS DEVELOPED COUNTRIES[2]



Take Vietnam. As capitalism takes root, Vietnamese cities are growing and industrial parks are springing up around the country. In 2009, Samsung built a $700 million cell-phone plant in Hanoi and in October 2010 Intel invested $1 billion in a semiconductor assembly and test facility near Saigon. Income levels are on the rise and the country's demographic picture is strong, with more than half of Vietnam's 86 million citizens under the age of 25.[3]

Much of what is currently happening throughout emerging markets is reminiscent of Japan in the aftermath of World War II. After losing about 40 percent of its industrial base during the war, the country underwent an economic revolution in the 1950s. Investments poured in and Japan began producing everything from synthetic fibers to ships. People started moving to the cities for work and income levels soared. With their newfound buying power, Japanese consumers gobbled up household goods. Between 1953 and 1955, sales of washing machines quadrupled, doubling again one year later. Demand for cars and televisions also exploded.

In China we are seeing the same sort of exponential increase in demand for consumer goods as more of the population moves to urban centers. Currently, 47 percent of the Chinese population lives in cities and this figure is expected to grow to 63 percent by 2020. Since 1986 the average income of city dwellers has increased 15 percent annually, and much of this income is spent on consumer goods. This spending is supported by a wider availability of consumer credit – last year, credit card balances grew by 17 percent. These spending trends are only expected to continue as the population gets younger and richer. By 2015 half of the population will be under the age of 35, while real wages are expected to increase to $5,900 per year from the current level of $3,500 per year.[4]

Roosevelt Investments' Approach

How does Roosevelt Investments seek to turn this trend into an investment strategy? Generally speaking, we select our investments after identifying economic, political, social, demographic, and industry-specific undercurrents that can be translated into long-term investment themes. **At Roosevelt, "the emerging consumer" is one such theme.** Once we have identified a theme, we conduct intensive research and apply rigorous fundamental financial analysis in order to identify companies that we believe are positioned to benefit from the shift. We also look for secondary and tertiary players that stand to profit from the ripple effects caused by social, demographic and economic changes.

For example, we believe pharmaceutical companies that sell drugs for hypertension and diabetes in countries such as India and China are poised for future gains. Why? Because as people move to the city and their income levels rise, their eating habits often change in favor of processed foods high in fat and sugar. While at the same time, they tend to exercise less. These changes contribute to weight gain and obesity, increasing the risk for diseases such as diabetes.

In the last decade, as India's economy grew 7 percent annually and 400 million people entered the middle class, the country also achieved another milestone: It became the country with the highest number of diabetics. Today, 7.1 percent of the population suffers from the disease. The average age of diabetes onset in India is 43, ten years younger than in Europe. And an estimated one million Indians are expected to die from the disease this year, more than in any other country.[5]

Roosevelt Investments

As we monitor the situation in many emerging markets **we also keep our eyes on changes in per capita average income since we know that demand for particular goods and services explodes once income levels cross certain thresholds.** For instance, once the average income crosses $10,000 per year car sales generally take off, and after the average salary exceeds $15,000 per year people start demanding long-term savings products, a trend explained by the **Acceleration Principle**.[6] According to this theory, as average income rises the number of people earning above average income accelerates well beyond the percent increase in average income. For example, in a country where the average income is $10,000 per year, 2.3% of the population will earn more than $15,000. However, when average income increases 25% to $12,500, the number of people earning more then $15,000 will jump by 600% (Figure 2).

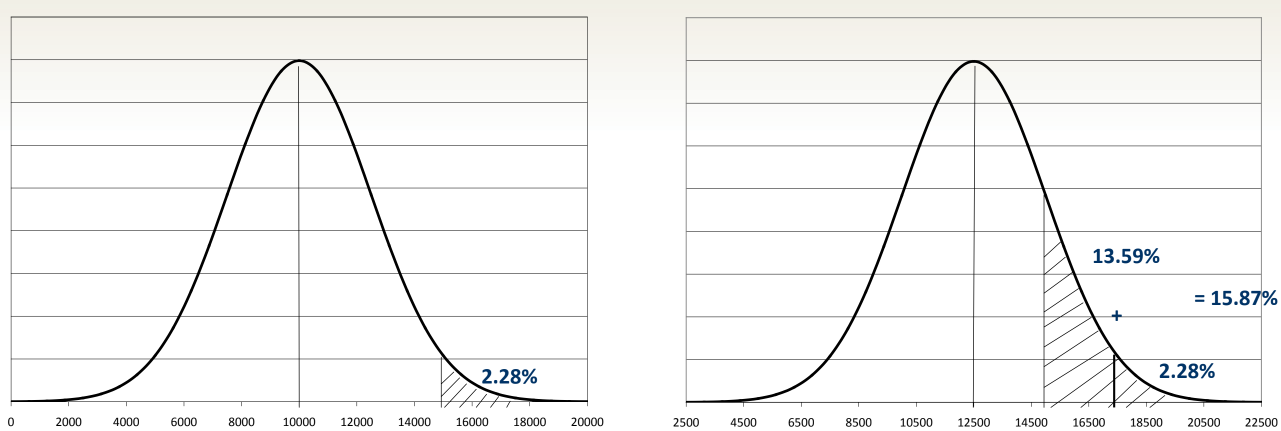
Over the past year, **we have seen the Acceleration Principle in action in China**, where per capita income rose 10% but car sales rose about 50% in first six months of 2010.[7] Similarly, in India as average incomes have increased the homegrown car manufacturing sector has expanded. As a result of these trends, we became interested in Indian car company Tata Motors, which has an interesting approach both to the local market and underdeveloped countries.

Of course, there are risks that all emerging markets pose, just as they did in Japan in the aftermath of World War II. Throughout many emerging markets today, political risks, terrorism as well as the possibility for speculative bubbles raise concerns. And the "frontier" economies in Africa, the former Soviet Union, the Middle East and Latin America present additional challenges. In these countries, instability,

FIGURE 2. ACCELERATION PRINCIPLE, HYPOTHETICAL ILLUSTRATION

When average income is $10,000 2.28% of population will cross the $15,000 income threshold

When average income reaches $12,500 15.87% of population will earn more than $15,000 in income



Source: "The Acceleration Phenomenon." Gavekel Five Corners. July 10, 2003.

war, limited property rights, weak rule of law, poor infrastructure and/or rampant corruption may threaten to undermine economic growth.

Yet, even in light of these risks we believe that the economic growth and demographic shifts many developing countries are experiencing create an attractive environment for investment. Through our emphasis on thematic investing, we are focused on identifying undervalued securities that we believe stand to benefit as the global middle class continues to grow. ■

SOURCE DISCLOSURES

[1]"Is this the 'BRIC's Decade?" BRICs Monthly, Goldman Sachs, May 2010. *Note: The emerging middle class is defined as earning annual income between $6,000 and $36,000.*

[2]"Inversion of Global Economies and Capital Markets," Falcon Private Bank, pg. 7.

[3]CIA world facts, https://www.cia.gov/library/publications/the-world-factbook/geos/vm.html, November 2010.

[4]World Population Prospects: United Nations Population Information Network, http://www.un.org/popin.

[5]"In India, diabetes spreads alongside prosperity," Bloomberg News Service, http://www.boston.com/news/world/asia/articles/2010/11/21/in_india_diabetes_spreads_alongside_prosperity, November 21, 2010.

[6]The Acceleration Principle is rooted in the work of Thomas Nixon Carver, Albert Aftalion, C.F. Bickerdike and John Maurice Clark, "The Aftalion-Clark Accelerator," http://homepage.newschool.edu/het//essays/capital/accelerator.htm

[7]The China Association of Automobile Manufacturers, http://www.chinaautoreview.com/pub/CARList.aspx?ID=11, October, 2010.

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Nainesh Shah, CFA, joined Roosevelt Investments in 2002 as a Senior Securities Analyst, having previously served as a member of the investment management team at Sheer Asset Management. Mr. Shah has 16 years of investment experience and is responsible for equity coverage of a broad spectrum of industries with a particular focus on the financial, communication and technology industries. He is also actively involved in the quantitative analysis employed in the firm's risk modeling process. A native of Bombay, he earned a bachelor's degree in Industrial Engineering from the University of Baroda, India, and an MBA in Finance from the Dalhousie University in Halifax, Nova Scotia. Mr. Shah is a Chartered Financial Analyst and is a member of the New York Society of Securities Analysts.