MARKET LETTER

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"Gray" Matters

by Dean M. Dordevic

"The power of population is so superior to the power of the Earth to produce subsistence for man, that premature death must in some shape or other visit the human race. The vices of mankind are active and able ministers of depopulation. They are the precursors in the great army of destruction, and often finish the dreadful work themselves."
—Reverend Thomas R. Malthus, 1798[1]

The Reverend Thomas Malthus infamously predicted that our day of reckoning would arrive around mid-19th century. Malthus hypothesized that our planet would be unable to keep up with surging population growth and we would, quite simply, run out of food. We all can be thankful that Malthus' predictions, controversial even in their day, did not come to pass.

Malthus was an economist and demographer who was known widely for his view that resources, particularly food, would not be able to keep pace with the world's growing population. While Malthus could count Charles Darwin as his fan, that was not the case with Karl Marx. Ironically, it was Marx who argued that Malthus did not fully recognize human capacity to increase food supply. Darwin failed to recognize that while demographic patterns are tantalizingly rich in both information and predictive power, they are far from perfect. We offer the aforementioned caveat since demographic Kool-Aid goes down so easily. We are cautious about being transfixed by its potential predictive powers. It is undeniable, however, that we are on the cusp of a global demographic transition—the likes of which we have really never experienced before.

Modern Malthus

A population almost the size of Germany is added to the planet each year, and the equivalent population of one new city is created every single day. Each year about 56 million people die and are replaced by 137 million live births, creating an annual increase in population of 81 million people. Over the next 40 years, the Earth's total population will increase by about 3 billion. While these numbers are stunning, they represent a *slowing* growth rate of the global population base. By way of example, the Earth's population grew by 2 billion in the relatively short 25 years from 1980 through 2005. The world's population growth rate has now slowed from 2 percent per year in the 1960s to just over 1 percent currently.[2]

When it comes to global demographics, there are countries and regions that can be described quite literally as "haves" and "have nots." What the demographic tea leaves are now telling us is that while population growth in the developing and emerging countries are generally robust—in much of the *developed* world, population growth is not only slowing but about to decline. So while the

FERGUSON WELLMAN
CAPITAL MANAGEMENT

888 SOUTHWEST FIFTH AVENUE, SUITE 1200
PORTLAND, OREGON 97204
503 226 1444 www.fergusonwellman.com

world's population growth is slowing down, the additional 3 billion people inhabiting the globe will *almost all be counted in the developing countries.*

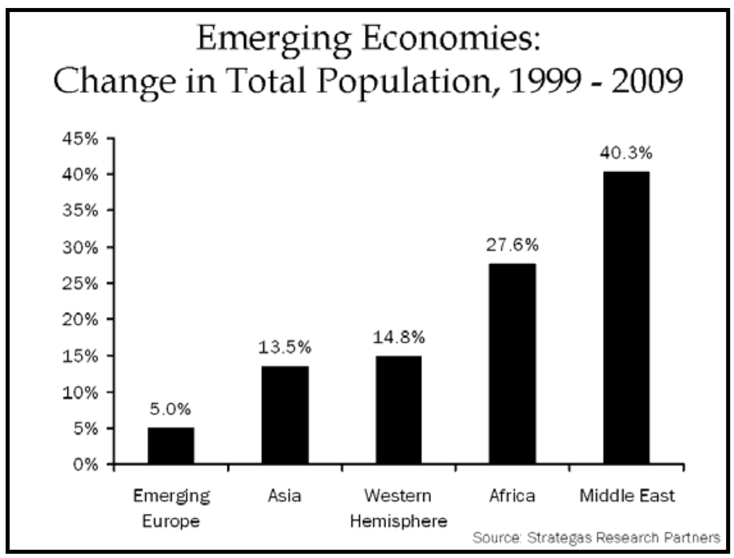
Demographic Death Row

> *"Over the next four decades, most of the developed countries in both Europe and East Asia will become veritable old-age homes: a third or more of their populations will be over 65, compared with only a fifth in America. Like the rest of the developed world, the U.S. will certainly have to cope with an aging population and lower population growth, but in relative terms the country will boast a youthful, dynamic demographic." – Joel Kotkin, Distinguished Presidential Fellow at Chapman University*[3]

In the global demographic demolition derby, the U.S. looks much better than its developed world peers. By 2050, the U.S. population is expected to rise from 305 million to about 402 million. The only other countries in the developed world expected to have either slowly growing or stable populations are the United Kingdom, Scandinavia (Denmark, Sweden and Norway), Mexico and Turkey.[2]

In the developed world, the biggest loser will be Japan where the population will shrink by about 26 million (20 percent) to 102 million by 2050. Japan is also unusual because it has virtually no net immigration. Over that same time frame, Europe's population will decline by 67 million (9 percent) to 664 million. The declines in the European continent will come mostly from declines in Russia and Eastern Europe. If we consider only those countries currently in the European Union, it is anticipated that population growth will be about flat versus current levels by 2050.[2]

If you look at the balance of the globe, the fastest population growth will come from Sub-Saharan Africa, the Middle East and North Africa. Not surprisingly, India will be the largest contributor to the world's population growth by 2050.



India's population will grow by almost 500 million over that time frame. It is anticipated that India's population will either equal or eclipse China's by 2050.[2] In a relative sense, we can count China as a "have not" since its population of 1.3 billion today will grow by only 80 million over the next 40 years.

In 1950, only China, India, the U.S. and the Soviet Union had populations over 100 million. Today, there are 11 countries in that club, and by 2050 there will be 19. Today, Pakistan and Bangladesh *each* have more people than Germany and France *combined*. In 2050, the U.K. will be 20 percent smaller than Tanzania and 10 percent smaller than Afghanistan; Germany will be three-quarters the size of Turkey and Vietnam will be bigger than Russia and Japan.[2]

Gray Planet

Another important variable at work in the demographic calculus is life expectancy. Despite the best efforts of experts over the decades to forecast the leveling off of the average life span of humans, it continues to rise. Yet the data shows that not only are people living longer, but they are getting healthier in old age. In fact, severe illness is more often than not compressed into shorter time periods closer to the end of life. Over the last century, worldwide average life expectancy has about doubled. If you are fortunate enough to live in the U.S., each passing day adds about five hours to your life span. Over the last 10 years, the number of people in the U.S. over the age of 100 has also doubled.[4]

Timothy Dyson, professor of population studies at the London School of Economics and Political Science, says, "*In demographic terms, population growth was the main feature of the 20th century. Aging will be the main feature of the 21st century, although there will be substantial population growth too.*"

As investors looking forward, the global demographic landscape will look almost nothings like it has in the past. What's more, demographic correlations to the world's stock markets are eerily tight. This is not only true for the U.S., but also for most of the public markets that we have studied. There are myriad hypotheses that can be drawn from this work, and we have probably raised more questions that we have answered. Nonetheless, these are our *investable* conclusions:

Demographically, most of the developed world is challenged. The U.S. is a relative bright spot with large scale immigration and a fertility rate 50 percent higher than that of Germany, Japan and Russia ... and well above China and virtually all of Eastern Europe. Demographically driven investments would be best skewed toward the U.S., Scandinavia, and perhaps Mexico and Turkey. Companies with export concentrations to these countries would also be potentially attractive.

With an increase in the rate of economic growth due to a rising share of working-age people, the developing world is where the true "*demographic dividend*" is richest.[5] What's even more intriguing is the fact that their economies may be in fact *healthier* than many in the developed world over the long term. The average external debt of emerging economies in the G-20 is about 10 percent of the G-10 average. Total debt outstanding paints a similar picture. The average annual budget deficit of emerging economies is less than half of the G-7. Balance of payments is also more favorable in the emerging world. Perhaps most interestingly, emerging economies make up 54 percent of the world's population, yet only 27 percent of global GDP. On the other hand, the G-7 countries make up 10 percent of the world's population, and over one-half of global GDP.[6] With populations rising and levels of extreme poverty falling, (combined with the benefits of economic reforms made earlier this century) there is clearly room for a vibrant and growing new middle class in the emerging world.[7] Portfolio overweights in countries and companies that are leveraged to this powerful paradigm represent an attractive investment in our view.

Although his conclusions couldn't have been more off-the-mark, we are most grateful to the good Reverend Malthus for his unintentional lessons in the perils of single variable analysis. We are respectful and humbled by our knowledge of both his history and experience. We hope that our analysis proves to be more enlightened and potentially more fruitful. What we do know with uncommon certainty is that we are better investors for having thought this through.

Market Letter Sources and Footnotes:

1 Thomas R. Malthus, "An Essay on the Principle of Population," Chapter VII, page 61, 1798.
2 George Mangus, *The Age of Aging*, 2009.
3 Joel Kotkin, "The Kids Will Be Alright," *The Wall Street Journal*, January 23, 2010.
4 Matt Ridley, "Hourglass Refigured," *The Wall Street Journal*, January 23, 2010.
5 Dominic Elliot, "Crowd Gazing," *The Wall Street Journal*, February 3, 2010.
6 Ned Davis Research, "The Economies Look Healthier in the Long Term," February 16, 2010.
7 Strategas Research Partners, January 29, 2010.

Community & Civic Service Continuity

Continuity and longevity are important values to our firm, and we expect our employees to also apply these qualities to serving on nonprofit boards. Fifteen organizations have had multiple Ferguson Wellman employees serve in leadership roles; some examples include Oregon Health & Science University, Boys and Girls Club, Portland Art Museum, Oregon State University, Portland Business Alliance, March of Dimes and United Way of the Columbia-Willamette.

Ferguson Wellman's Helena Lankton, current Arlington Club president, with past presidents Jim Rudd and Joe Ferguson (retired)
Photo by Bruce Beaton

Recently, Helena Barbey Lankton was elected as president of Arlington Club in Portland, an organization dating back to 1867 whose original civic-minded members included William Ladd and Henry Failing. Her election is particularly notable for three reasons. Lankton is her fourth family member, representing three generations invited to join Arlington Club. In fact, she was sworn in as president under the portrait of her grandfather Henry Barbey. Lankton is the third person from Ferguson Wellman to serve as president. Lastly, and perhaps what we are most proud of, she is the *first* woman president in the club's 143-year history.

Also serving in leadership roles this year include Lori Flexer, CFA, board chair of Friends of the Children and Marc Fovinci, CFA, board president of Portland State University Foundation.

The Value of Planning

During the first quarter of 2010, we presented our *Investment Outlook* for the year through 14 events in eight cities, reaching more than 450 clients and professional partners. For clients residing in cities where a hosted event was not arranged, we shared our perspective through face-to-face meetings and web-based videos. With heightened interest at the beginning of the year, we were able to connect with clients on where the markets closed and what investment opportunities lay ahead. We appreciated all the questions and commentary that came from these discussions.

This quarter, we shift our communication emphasis with clients to planning. In addition to sharing past performance, asset allocation and sector weight shifts through our quarterly reports and meetings—we feel that now is a good time to revisit both short and long-term goals that could be impacted by clients' investments and spending. For our **individual and family clients**, we recommend arranging a meeting to go through *Horizon*™, our proprietary financial planning tool that analyzes real-world factors to forecast long-term outcomes. We have found that this process triggers questions clients may have and enables us to better align our investment strategies with their financial goals. Other resources we can provide include our *budgeting worksheet, 529 college savings plan calculator, Social Security payment analyzer and Roth IRA conversion calculator*. For **corporate and union clients**, we welcome the opportunity to share these important resources with their employees in a group setting or through email or web-based communication. In serving our **foundation and endowment clients**, distributions are an important way we provide value in the planning process. We analyze current distribution rates and sustainability plans through *Horizon*™ to make investment recommendations and align asset allocation accordingly.

Please do not hesitate to contact your portfolio manager this quarter regarding these planning resources, or anytime throughout the year that is convenient for you.