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**UNITED STATES**

## Thematic Investing

April 22, 2004

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# The Next American Dream

## Healthy, Wealthy, and Active: The Baby Boomer in 2010

- **As they have all their lives, baby boomers — Americans born between the years 1946 and 1964 — will remain the most influential segment of the population.**
- **With the oldest boomers soon facing their 60s, their mindset and attitudes are changing and so, too, is the contour of the American Dream. The next American Dream is to be healthy, wealthy, and active. However, a gap between these aspirations and reality should be a key factor driving the behavior of baby boomers.**
- **Health conscious boomers are, by and large, obese and living unhealthy lifestyles. Wealthy boomers will enjoy good incomes largely by working after retirement. Active boomers want to work, but be able to take a day off when they want, while their leisure preference is “lazily active.”**
- **We believe the following areas are well positioned. *Healthy:* Managed health care, generic pharmaceuticals, and biotech companies. *Wealthy:* Advisory-based brokers, asset managers, selected insurance companies. *Active:* Homebuilders and home improvement, high-end hotels, casinos, and cruise lines.**
- **Poorly positioned industries, in our view, include some surprises such as large pharmaceutical companies, jewelry retailers, bookstores, and traditional mortality protection life insurers.**

United States

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***With the oldest baby boomers soon facing their 60s, their mindset and attitudes are changing and so, too, is the contour of the American Dream. The next American Dream is to be healthy, wealthy, and active. However, a gap between these aspirations and reality should be a key factor driving the behavior of these baby boomers.***

**Many boomers paradoxically find themselves living an unhealthy lifestyle and taking medications to remain active.**

Two in three boomers (68%) say they “care about” maintaining a healthy weight; less than half (47%) are “currently doing” things that help keep them in shape. Only one in ten boomers (12%) say they have attained their goal of “adopting a healthy lifestyle.” And more than one in four boomers aged 50–59 are obese.

With health care costs rising rapidly, employers are trying to push a greater share of expenses onto employees who, as a result, are likely to increasingly use generics, import medications from overseas, and possibly reduce their consumption of pharmaceuticals they perceive to be relatively unimportant. The establishment of Health Savings Accounts (HSAs) will likely only add to the pressure on large pharmaceutical companies, but will likely be relatively favorable for selected managed health care, generic pharmaceutical, and biotech companies.

**Affluent boomers are confused about investing and need advice about their finances.**

Thanks to aggressive investing and a generally favorable investment environment, *boomers have accumulated significant wealth.* The median net worth of people in the 45–54 age group is almost *twice* that of those in the 35–44 age group, with the median net worth of those aged 55–64 even higher. Yet only 26% of boomers “always know which types of investments are right for me.” Just 27% describe themselves as “somewhat experienced” investors.

Boomers are generally conservative investors and want financial advice. Because they will likely be working past retirement age and living longer than ever before, boomers want to know how to preserve capital in a volatile financial environment.

**Active boomers want a balance between work and personal life; in their leisure time, boomers are lazily active.**

Three in five boomers (62%) consider it important to have “a successful balance between work and personal life.” More than half of boomers (54%) value “being able to take a day off when you want to,” yet nearly 70% of workers who have not yet retired plan to work into their retirement years or never retire, but only 25% will work because they need the money.

“Actively working” boomers live in “jewel boxes” — relatively small houses with professional-grade kitchens and luxurious bathroom designs — and drive top-of-the-line vehicles crammed with “up-contenting” features.

Forty-seven percent of boomers like to walk as a leisure activity, but only 15% run when they exercise. Forty-two percent of boomers have taken a cruise in the past five years, but only 11% swim when they exercise. Thirty-eight percent of boomers like to go for a drive in their spare time, but only 11% go hiking. Thus, boomers are “lazily active.”

“Actively relaxing” boomers favor leisure activities that are outdoors or away from home and engaging, rather than those that are indoors and passive. They are going away to high-end hotels to gamble and hunt for antiques, rather than staying home to watch a movie or play a video game.

**Surprise! Four “obvious” hypotheses about consumer behavior proved to be invalid.**

While boomers are taking a lot of medications, this is not necessarily bullish for the profit growth of large pharmaceutical manufacturers, which will likely be pressured on the demand side by HSAs and, on the supply side, by generics and imports from overseas.

While boomers are financially conservative, the demand for traditional mortality protection-oriented life insurance policies is curbed by rising life expectancy, as well as the fact that the older boomers’ grown kids are no longer financially dependent on their parents.

Despite the recent stock market experience, the “equity culture” is not dead. Seventy-three percent of investors who moved out of investments and into bank accounts said that they planned to move the money back into their investment accounts once the investment outlook improves.

Boomers are not couch potatoes who want to stay home and take a nap, watch a video, or surf online. They prefer leisure activities that are outdoors and engaging to those that are indoors and passive.

**There are potential risks to our thematic outlook.**

A key risk to the Next American Dream is that the patterns suggested by the historical and/or attitudinal data do not develop as expected. Another risk is that, even if these patterns do develop as expected, companies, industries, and sectors are unsuccessful in their efforts to take advantage of these trends. In addition, there are also near-term cyclical risks to the consumer sector, such as surprising price inflation or deflation, very slow economic growth, or an exogenous shock, such as a terror attack.

We further note that our analysis does not consider stock-specific metrics such as valuation, EPS, and P/E, or balance sheets, market capitalization, liquidity, etc. Accordingly, when making investment decisions, investors should view thematic analysis as only one input to their investment decision. Since thematic analysis employs a longer-term methodology, its results may differ from the conclusion of fundamental analysis. For example, in this report, we mention Avon Products and Four Seasons as being well positioned, but our fundamental analysts currently rate both stocks Sell owing to valuation.

**Figure 1. Industries Well Positioned and Poorly Positioned to Benefit from the Next American Dream**

<b>Theme</b>	<b>Well Positioned</b>	<b>Poorly Positioned</b>
<b>Healthy</b>	Biotech companies	
	Casual dining restaurants	Bread
	Generic drug manufacturers	Most large-cap pharmaceuticals
	Managed health care	
	Personal care products	
	Seafood restaurants	Fast-food restaurants
	Selected wholesale clubs	
	Vitamin & supplement retailers	Tobacco
	Wine and spirits companies	Beer; Carbonated drink makers
<b>Wealthy</b>	Advisory-based brokers	Consumer banks
	Selected asset managers	
	Selected insurance companies	Traditional mortality protection life insurers
<b>Active</b>	Auto interior suppliers	Auto parts retailers
	Building products manufacturers	
	Casino operators	Selected theme-park owners
	Cruise line operators	
	Gaming equipment manufacturers	
	High-end hotels	“Commodity” hotels
	Home improvement stores	Jewelry retailers
	“Lifestyle” retailers	Department stores
	Pet supply retailers	Bookstores
	Selected homebuilders	

Source: Smith Barney

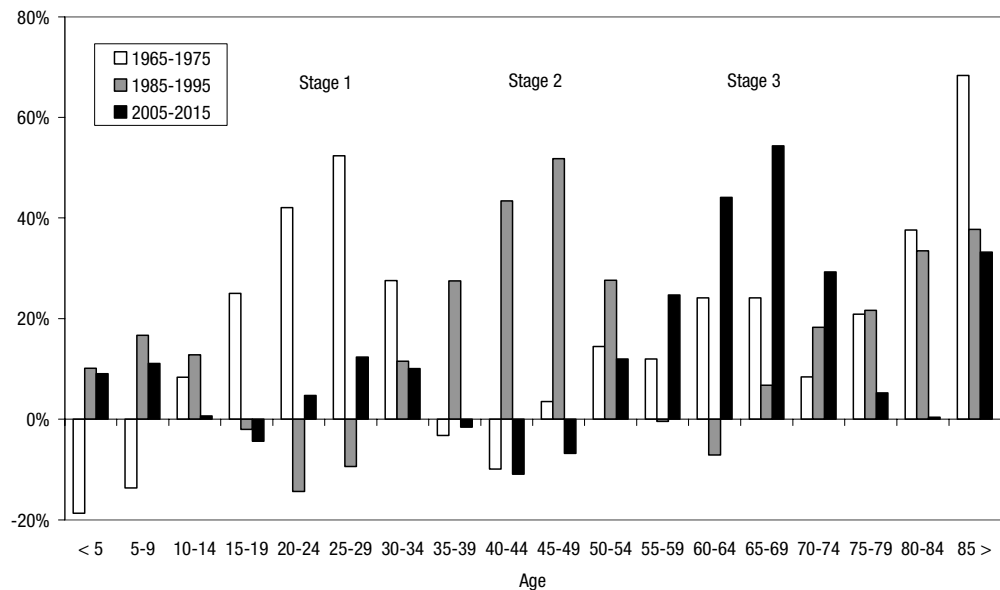
# The Next American Dream

*The fastest-growing age group in the decade 2005–15 will be the 60–69 year olds.*

## Healthy, Wealthy, and Active: The Baby Boomer in 2010

The key baby boom generation that has defined the consumer sector for the past four decades continues to age. Many boomers — the post-World War II surge of Americans born between the years 1946 and 1964 — are now in their 50s, with the oldest boomers set to turn 60 in 2006. Consequently, the fastest-growing age group in the decade 2005–15 will be the 60- to 69-year-olds (see Figure 2).

**Figure 2. U.S. Population Growth by Age Group over Three Ten-Year Periods, 1965–2015E**



Source: U.S. Bureau of the Census International Data Base

For the foreseeable future, boomers will remain the most influential segment of the population, as they have been all of their lives.

*Boomers will remain the most influential segment of the population.*

- In the first stage — the 1960s and 1970s — the young boomers had little spending power (reflecting a generally weak economy, as well as the fact that they were far from their peak earning years), yet they had a tremendous influence on social issues ranging from the Civil Rights and Equal Rights movements to the War on Poverty. This was the “me generation,” characterized by the burgers they ate, the sodas they drank, and the jeans they wore.
- In the second stage — the 1980s and 1990s — the middle-aged soccer moms and dads — then in their peak earning years — drove the consumer comeback that energized the U.S. economy in the second half of the 1990s. They elected Ronald Reagan, bought BMWs, and favored conspicuous consumption.
- And now, soon facing their 60s with their children largely grown up, boomers are in the third stage of their lifecycle. Consequently, their mindset and attitudes are changing and so, too, is the contour of the American Dream. As we discuss in detail below, we believe the next American Dream for these boomers is to be

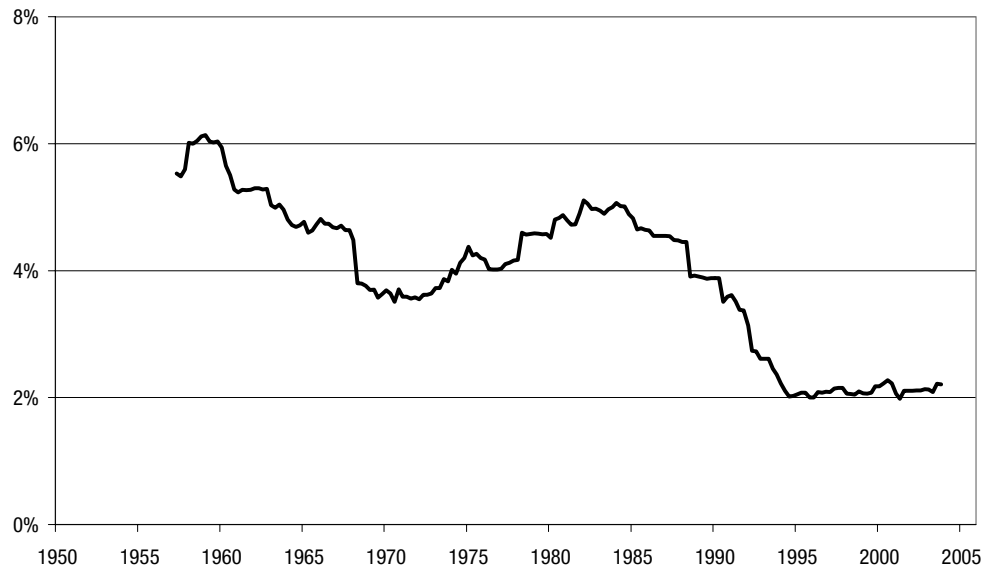
healthy, wealthy, and active. However, the effort to realize that dream involves many contradictions:

- A high number of health-conscious boomers are actually obese.
- Wealthy boomers will enjoy good incomes largely by working after retirement.
- Active boomers want to stay in the labor force but be able to take a day off when they want. Moreover, their leisure preference is to be lazily active.

***Concomitant with the demographic evolution of the baby boom generation, the economic cycle has also matured and is much less volatile.***

Concomitant with the demographic evolution of the baby boom generation, the economic cycle has also matured and is much less volatile (see Figure 3). In essence, like the boomers themselves, the economy is in the third stage of a transformation, following the transition from the inflationary post-World War II boom-bust industrial economy (Stage 1) to the disinflationary service economy of the 1980s and 1990s (Stage 2). This latest transformation has been labeled “the muted business cycle” or, alternatively, the “great moderation.”

**Figure 3. Ten-Year Rolling Standard Deviation of GDP Growth, 1957–Present**



Source: Bureau of Economic Analysis

***Key demographic and economic trends have been intertwined.***

Importantly, in the past, key demographic and economic trends have been intertwined, so that one has reinforced the other (as opposed to a cause and effect relationship). So, for example, the fact that the young and inexperienced baby boomers flooded the workforce in the early 1970s made it difficult to boost productivity (and living standards) during a period that was prone to sharp economic downturns. By contrast, in the strong economy of the late 1990s, with the influx of women and baby boomers into the workforce largely complete, the labor supply grew tight just as boomers were entering their peak earning years. Today it seems likely that stable demand by older boomers will coincide with an extended period of low economic volatility.

In this report, we examine the older boomers and how we expect 1) the normal process of aging, 2) the changing economic landscape, and 3) shared life experiences to drive their behavior (see Figure 4). To that end, we dug into the economic data, enlisted the help of a leading expert on consumer behavior, and collaborated with Smith Barney analysts:

- The Bureau of Labor Statistics’ (BLS) annual Consumer Expenditure Survey (CES) collects information from the nation’s households and families on their buying habits (expenditures), income, and characteristics (e.g., age and education). The 2002 CES, released in November 2003, is the most recently available.
- For 30 years, Yankelovich Partners have been compiling comprehensive polls about consumers’ preferences, habits, and lifestyles. Key results of Yankelovich’s proprietary 2003 report on consumer behavior, *The Yankelovich MONITOR*, are discussed throughout the report.
- More than a dozen Smith Barney analysts covering the consumer, health care, and financial sectors provided their insights on the investment implications of changing boomer behavior.

***Some “obvious” hypotheses about consumer behavior seemed to make intuitive sense, but upon further investigation proved to be invalid.***

Importantly, this “triple-check” helped weed out hypotheses about consumer behavior, which seemed to make intuitive sense, but upon further investigation proved to be invalid. Consider the following:

- With boomers taking so many medications, this has to be bullish for the profit growth of large pharmaceutical manufacturers — right? Wrong! With health care costs rising rapidly, employers are trying to push a greater share of expenses onto employees who, as a result, are likely to increasingly use generics and import medications from overseas, as well as possibly reduce their consumption of pharmaceuticals they perceive to be relatively unimportant.
- With many boomers now in their 50s, this has to be bullish for companies selling traditional mortality protection oriented life insurance policies — right? Wrong! Life expectancy is rising, and boomers are living much longer than ever before. Moreover, boomers’ kids are largely grown and are no longer financially dependent on their parents.
- The recent stock market experience will keep boomers away from stocks — right? Wrong! The “equity culture” is not dead. In fact, affluent investors most frequently blamed corporate executives and themselves for stock market losses. While 22% of affluent investors said they had reallocated funds from investments to their bank account, 73% said that they planned to move the money back to their investment accounts once the investment outlook improves.
- In their leisure time, tired, stressed out, and hardworking boomers are couch potatoes who want to stay home and take a nap, watch a video, or surf online — right? Wrong! These boomers are “actively relaxing,” preferring leisure activities that are outdoors and engaging rather than those that are indoors and passive.

**Figure 4. Behavior Is Shaped by Common Experiences**

*“Marketers have often defined ‘generation’ as a group of people who share the same formative experiences.”*

	Baby Boomers ('46-'53)	Baby Boomers ('54-'64)	Gen X ('65-'78)
<b>Slogans</b>	Make Love, Not War	No Nukes	“Whatever”
<b>Question</b>	Where were you when JFK was shot?	Where’s the beef?	Boxers or briefs?
<b>Demonstration</b>	Chicago riots	No nukes march	Battle of Seattle
<b>The 60s</b>	Participants	Witnesses	Oliver Stone movie
<b>Jewelry</b>	Peace symbol necklace	POW bracelet	Nose ring
<b>Journalist</b>	Hunter Thompson	John F. Kennedy Jr.	Matt Drudge
<b>News</b>	Walter Cronkite	CNN	CNN.com
<b>Gathering</b>	Woodstock	Live Aid	Lollapalooza
<b>War</b>	Vietnam	“Star Wars”	Persian Gulf War
<b>Hero</b>	JFK	Jerry Brown	Jesse Ventura
<b>Magazine</b>	Ramparts	George	Drudge Report
<b>Scandal</b>	Profumo affair	Watergate	Monicagate
<b>Gesture</b>	Burn draft card	Streaking	Moshing
<b>Hot Spots</b>	San Francisco	Austin	Seattle
<b>Filmmakers</b>	Oliver Stone	Spike Lee	Kevin Smith
<b>Feminist</b>	Gloria Steinem	Naomi Wolf	Courtney Love
<b>Poet</b>	Bob Dylan	Bruce Springsteen	Kurt Cobain
<b>Season</b>	Summer of Love	Spring Fever	Winter of Discontent
<b>Anti-</b>	Anti-war	Anti-nuke	Anti-WTO

Source: Jonathan Pontell, “Generation Jones” (Vanguard Press)

*“A Generation Defined:* Among Webster’s definitions of generation is the following: ‘a category of people born and living contemporaneously.’ Marketers have often defined ‘generation’ as a group of people who share the same formative experiences. These experiences bind people that are born in continuous years into ‘cohorts’ — a group of individuals that have a demographic statistic in common.”<sup>1</sup>

<sup>1</sup>“Generation Divide,” Alison Stein Wellner, *American Demographics*, Oct 1, 2000.

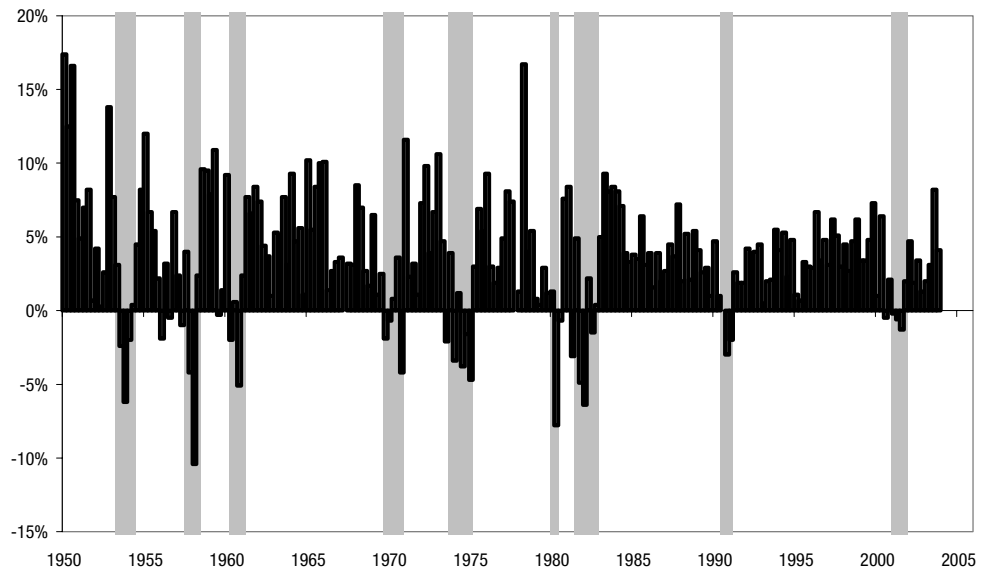
## “The Great Moderation”

*Over the past twenty years or so, macroeconomic volatility has declined significantly.*

We began to write about a muting of the business cycle in 1996. That the economy is now more stable has lately become a topical subject in economic and academic circles. In a recent speech entitled “The Great Moderation,”<sup>2</sup> Federal Reserve Governor Ben S. Bernanke observed that “one of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility.” Between 1950 and 1982, there were seven recessions, or one every 4.6 years; since 1982, there have been just two recessions in 22 years (see Figure 5).

**Figure 5. Annualized Quarterly Real GDP Growth, 1950–2003**

Recessions shaded



Source: Bureau of Economic Analysis

**A steady decline in volatility has been the norm, not the exception.**

In his speech, Governor Bernanke referenced the work of Blanchard and Simon<sup>3</sup>, who documented that the variability of quarterly growth in real output (as measured by its standard deviation) has declined by half since the mid-1980s (see Figure 3). Importantly, whatever the exact cause(s) of the reduced volatility (e.g., improved inventory management thanks to better information technology, more effective monetary policy, etc.), Blanchard and Simon illustrated that the decline in output volatility is *not* a recent development but rather “a steady one, starting in the 1950s (or earlier), interrupted in the 1970s and early 1980s, with a return to trend in the late 1980s and the 1990s.” In other words, *a steady decline in volatility has been the norm, not the exception* (see Figure 3).

<sup>2</sup> Remarks by Governor Ben S. Bernanke at the meetings of the Eastern Economic Association, Washington, D.C., February 20, 2004.

<sup>3</sup> *The Long and Large Decline in U.S. Output Volatility*, Olivier Blanchard and John Simon, March 10, 2000.

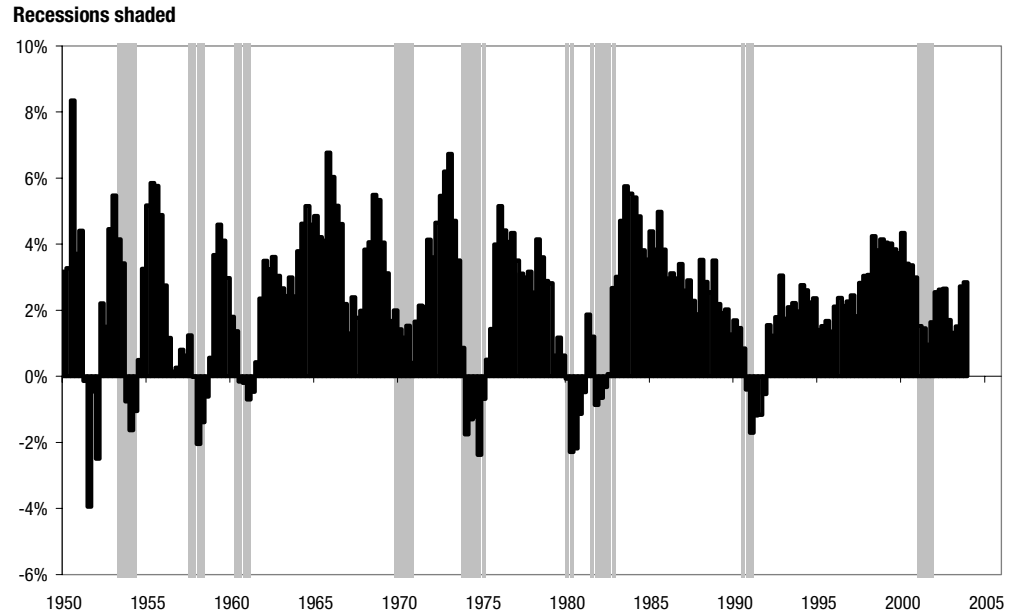
## Stage 1: 1960–1980

### Boom-Bust Misery; Ebullient Youthfulness

*The young baby boomers grew up in a golden period for the U.S. economy.*

Born into the prosperity of postwar America, the young baby boomers grew up in a golden period for the U.S. economy in general and the U.S. consumer in particular. Between 1961 and 1967, productivity growth was strong, economic growth was solid, there were no recessions, and yet inflation was remarkably restrained. Not surprisingly, consumption grew rapidly in the first half of the 1960s (see Figure 6).

**Figure 6. Real Per Capita Consumption Growth — Year-over-Year Percentage Change, 1950–2003**



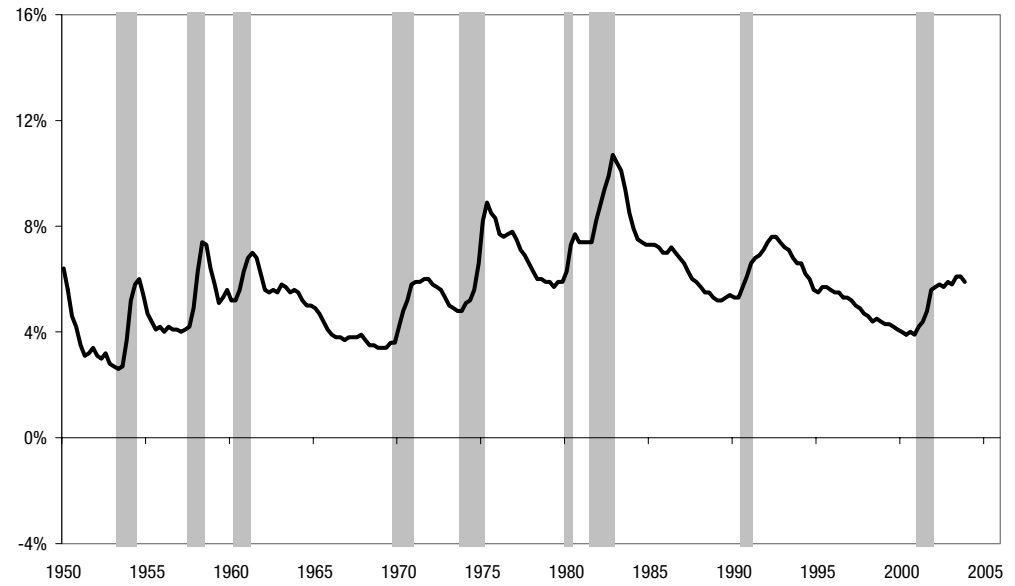
Source: Bureau of Economic Analysis

*In the late 1960s, a variety of factors led to secular inflation.*

In the late 1960s, however, a combination of factors led to secular inflation. First, President Johnson attempted to fight both the war on poverty (which included a new program called Medicare) and the war in Vietnam without raising taxes — even though the unemployment rate was only 4% in 1965 (see Figure 7). With the economy already booming, the twin wars against poverty and the Viet Cong stoked pricing pressures. At the time, there was a dearth of foreign competition to dissuade U.S. firms from raising prices to meet the demands of increasingly militant labor unions.

**Figure 7. Unemployment Rate, 1950–Present**

Recessions shaded



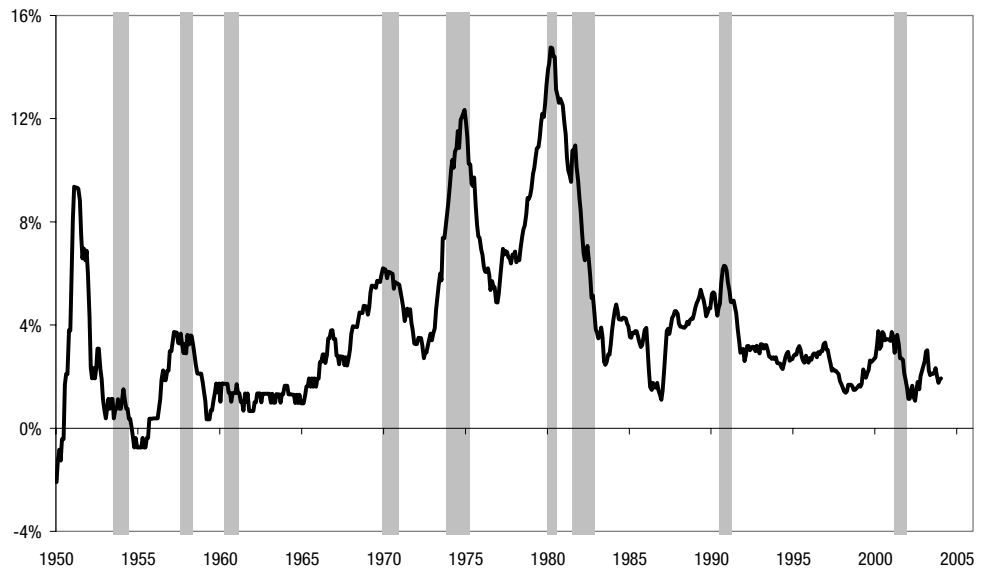
Source: Bureau of Labor Statistics (BLS)

*Rising inflation led directly to higher interest rates and, ultimately, to credit crunches, recession, and price controls.*

Rising inflation (see Figure 8) led directly to higher interest rates and, ultimately, to credit crunches (1966), recession (1970), and price controls (1971). Then food prices soared during 1973 and, in the winter of 1973–74, OPEC quadrupled the price of gasoline. Inflation rose above 10% in 1974.

**Figure 8. Inflation — Year-over-Year Percentage Change in the CPI, 1950–Present**

Recessions shaded



Source: BLS

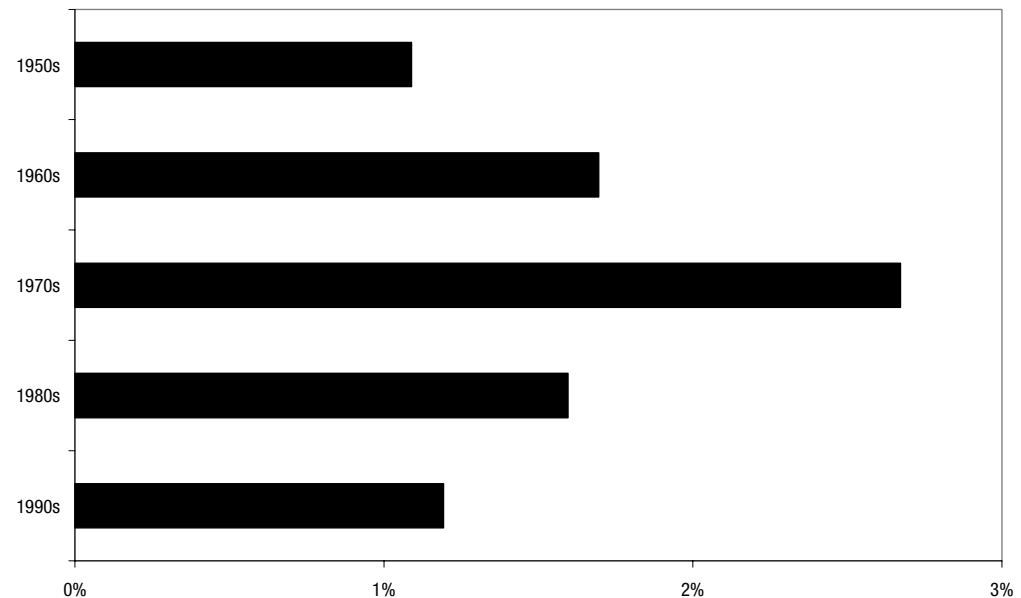
In 1975, the economy fell into a severe recession after the oil shock, when inflation ravaged consumer incomes and confidence as well as business confidence. But after the 1975 recession ended, inflation only got worse. Throughout the late 1970s, the newspapers were full of stories about the failures of the Carter Administration’s various schemes for containing inflation and gloomy news about their lack of success. Government regulation expanded in such areas as pollution, consumer product safety, and employment practices.

***Amid this inflationary, recession-ridden environment, the young baby boomers entered the labor force.***

Amid this inflationary, recession-ridden environment, the young baby boomers entered the labor force (see Figure 9). In terms of work options, many young boomers turned to giant bureaucracies, whether it was the corporation that offered a job for life, the union that fought for job security and better pay, or the sprawling government sector that already accounted for 20% of GDP in 1970.

**Figure 9. U.S. Labor Force Growth by Decade, 1950–1999**

Compound annual growth rate

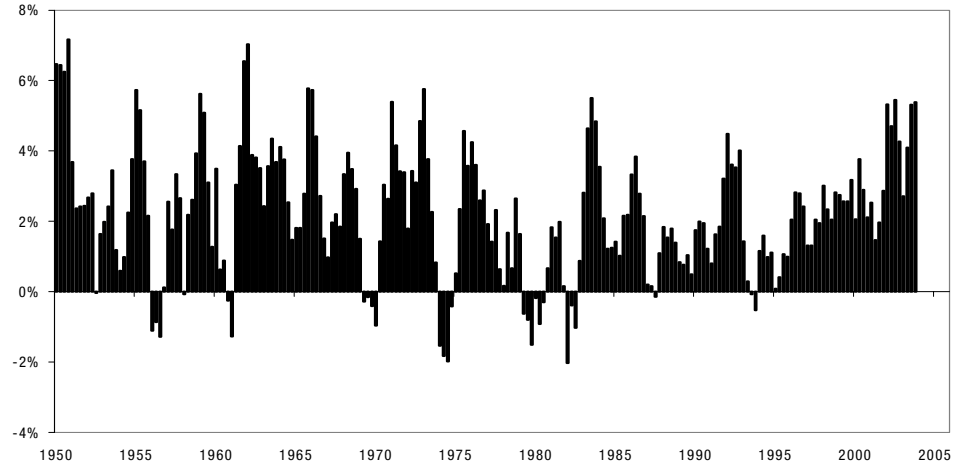


Source: BLS

***The large numbers of inexperienced workers in the workforce made it difficult to boost productivity.***

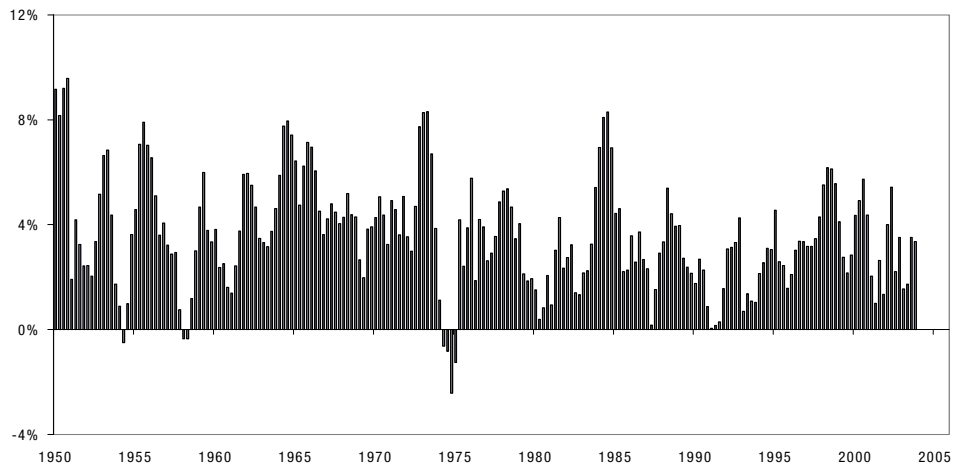
Importantly, the large numbers of inexperienced workers in the workforce during this period of rapid labor force growth made it difficult to boost productivity (see Figure 10). Consequently, after 1973, productivity growth declined and real incomes started to fall (see Figure 11). Not surprisingly, consumer confidence and per capita consumer spending steadily collapsed while the “misery index” — the sum of the inflation and unemployment rates — doubled, eventually reaching a peak of 22% in 1980 (see Figure 12).

**Figure 10. U.S. Nonfarm Productivity — Year-over-Year Quarterly Percentage Change, 1950–2003**



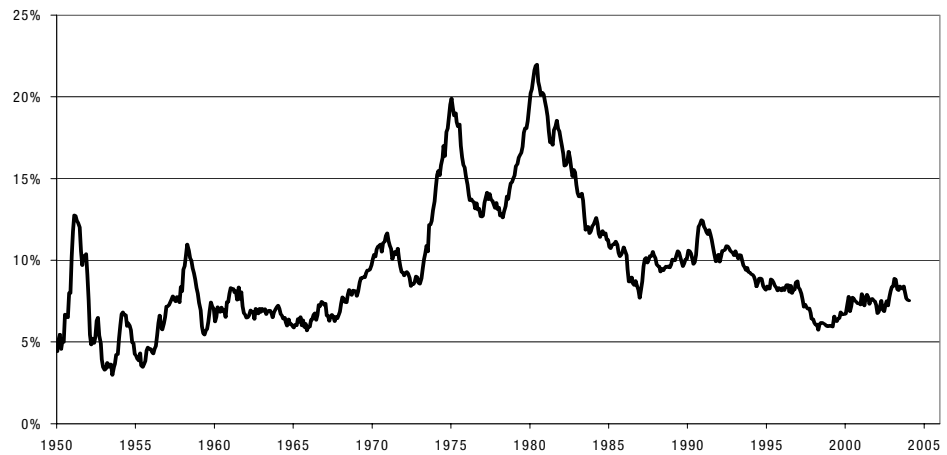
Source: BLS

**Figure 11. Real Disposable Income — Year-over-Year Percentage Change, 1950–2003**



Source: BLS

**Figure 12. Misery Index — Sum of Inflation and Unemployment Rates, 1950–Present**

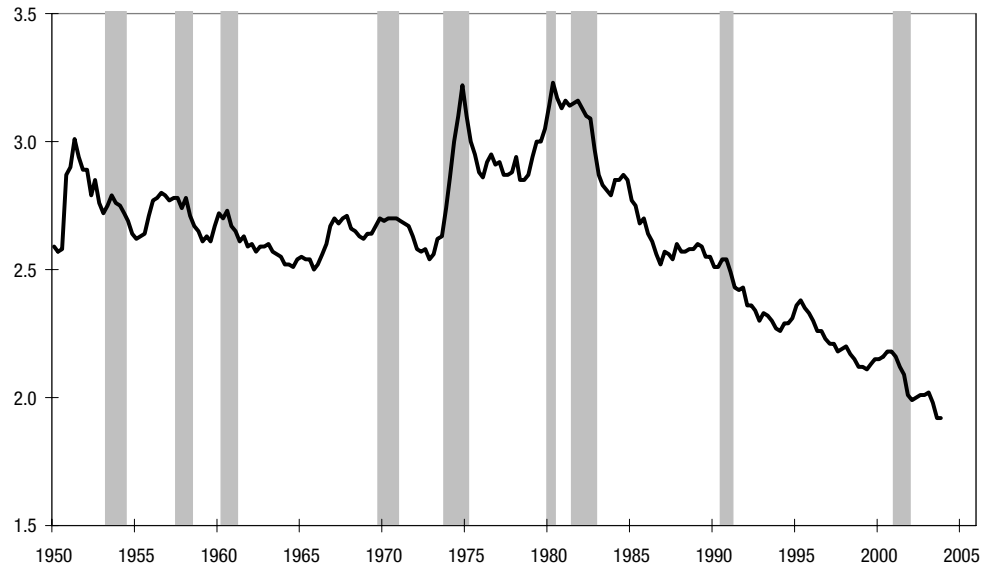


Source: BLS

As noted, in this period of boom-bust misery, recessions were a regular occurrence. Indeed, between 1950 and 1982, there were seven recessions, or one every 4.6 years. The frequent downturns were primarily caused by inventory corrections (see Figure 13), exacerbated by the prolonged tightening of an inflation-fighting Fed.

**Figure 13. Nonfarm Inventories to Final Sales Ratio, 1950–Present**

Recessions shaded



Source: Bureau of Economic Analysis

The fact that inventories remained at relatively high levels during the 1970s largely reflected a very industrialized economy (in which high capacity utilization was associated with high profit margins given heavy fixed costs) as well as poor information management. These high inventory levels made the economy particularly vulnerable to slumps in demand caused by Fed tightening. So it is not surprising that the really bad recessions occurred when inflation was high and the Fed was tightening aggressively, as was the case in 1975 and in 1981–82.

*While the young baby boomers were numerous and ebullient during the 1960s and 1970s, they were not in a position to have much of an impact on the economy.*

In summary, while the young baby boomers were numerous and ebullient during this first stage, they were not in a position to have much of an impact on the economy. First, they were still far from their peak earning years and as such had relatively little spending power. Second, whatever spending power they did have was sharply curtailed by rampant inflation and high interest rates.

## Stage 2: 1980–2000

### Falling Misery; Middle-Age Responsibilities

By the winter of 1979, the Consumer Price Index (CPI) was advancing at a 13% annual rate. Curbing that rampant inflation became a mandate for two newcomers to Washington D.C.: Paul Volcker (appointed Federal Reserve chairman in the autumn of 1979) and Ronald Reagan (elected president a year later).

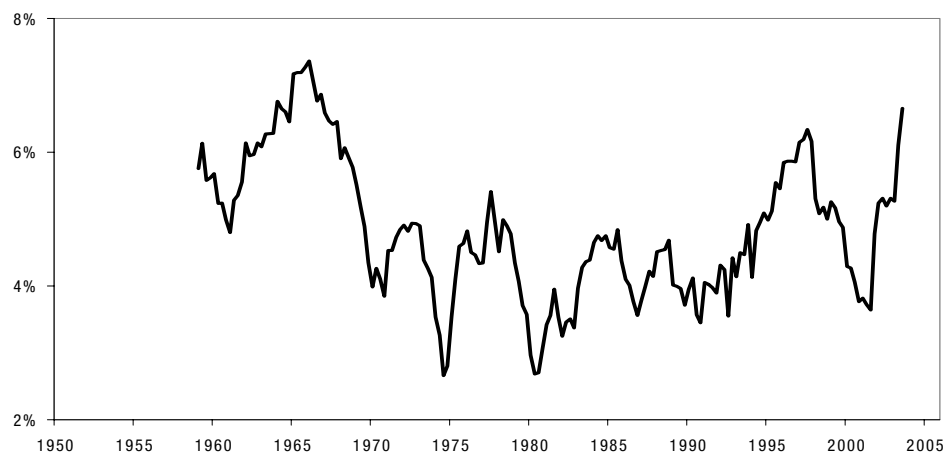
Mr. Volcker’s tight monetary policy caused a sharp but short recession in 1980. When that failed to curb inflation, Mr. Volcker tightened once again, leading to a much longer downturn that began in July 1981 and did not end until November 1982. As for President Reagan, the central tenets of Reaganism were reducing regulation, cutting taxes (federal income taxes were cut in 1983), trimming government spending (except defense), and taking an optimistic view of the future in contrast to the gloom of the Carter era.

*Falling inflation, lower taxes, fairly stable incomes, falling unemployment, a strong dollar, and surging stock prices reenergized the consumer sector.*

The favorable combination of falling inflation, lower taxes, fairly stable incomes (better than the sharp declines of the mid-1970s), falling unemployment, a strong dollar and surging stock prices reenergized the consumer sector. The misery index plunged (see Figure 12), and real per capita consumer spending rose as fast in the mid-1980s as it had in the early 1960s (see Figure 6).

While Reaganomics helped most consumers, it put severe pressure on many corporations that had grown accustomed to raising prices at will. Adding to disinflation were the high real interest rates of the mid-1980s, the strong dollar of 1983–85, and intense competition from industrializing countries in Asia. Corporate America moved to adjust to this harsh competitive climate by slashing headcount, spinning off less profitable businesses, and using new technology to reengineer operations. These initiatives produced a rebound in profit margins (see Figure 14), but consumers were hurt in the late 1980s by stagnating incomes, slow employment growth, and a loss of employment security. Consumption growth slowed sharply.

**Figure 14. After-Tax Profits as a Percentage of Gross Domestic Income, 1950–2003**



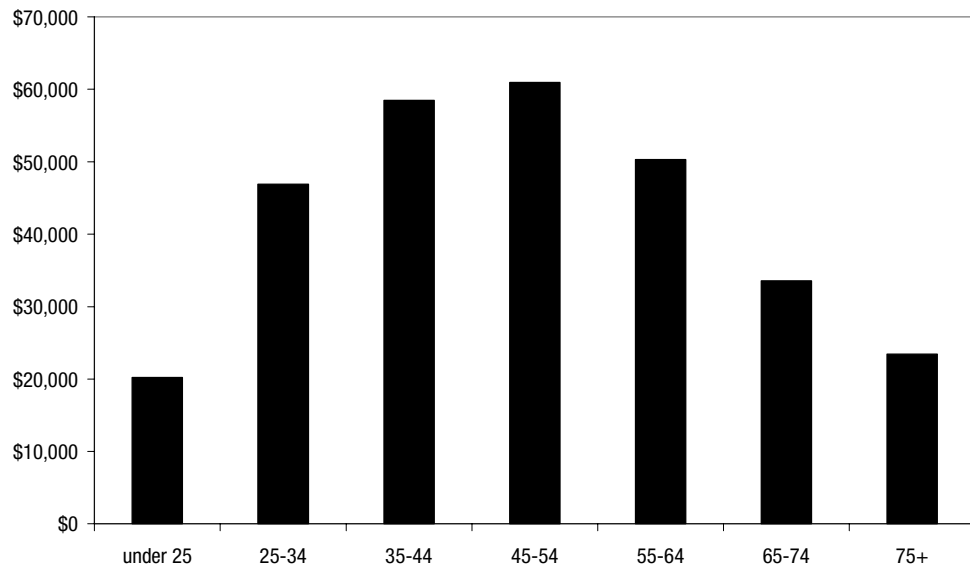
Source: Bureau of Economic Analysis

Consequently, in the late 1980s, the misery index rose again, driven by (as it turned out) a temporary increase in unemployment, as well as rising inflation spurred by a shift from very low oil prices in the mid-1980s to an energy price spike in 1991 (associated with the first Gulf War). But that period was only a pause in a two-decade long decline in the misery index. As it turned out, what was good for American corporations — rising productivity, low inflation, and a lengthy economic expansion — would prove to be good for U.S. workers as well. Corporate downsizing (as distinct from productivity improvement) could not go on forever. By 1995, continued economic expansion forced firms to raise wages in order to hire the workers they needed. Thanks to strong productivity and profit growth, corporations could well afford to raise wages.

**The drop in the misery index from 12% in the early 1990s to 6% in the late 1990s drove a consumer comeback.**

Indeed, it was the drop in the misery index from 12% in the early 1990s to 6% in the late 1990s that drove a consumer comeback. With the influx of women and baby boomers into the workforce largely complete, the labor supply grew more slowly in the late 1990s. Consequently, as the economic expansion continued, companies were obliged to raise wages as the unemployment rate declined. Importantly, not only did *nominal* incomes increase, so did *real* incomes, thanks to a continued decline in the inflation rate. Moreover, it was in the 1990s that the 40-year-old boomers were in their peak earning years (see Figure 15).

**Figure 15. Household Income Level by Age of Reference Person in 2002**



Source: Consumer Expenditure Survey (CES)

The consumer comeback of the late 1990s eventually evolved into an American age of affluence as the so-called peace dividend that followed the Cold War helped fuel a budget surplus and a period of unprecedented prosperity. The income of boomers — who, as we previously noted, were already in their peak earning years — was further boosted by the roaring stock market of the late 1990s, which generated plenty of capital gains.

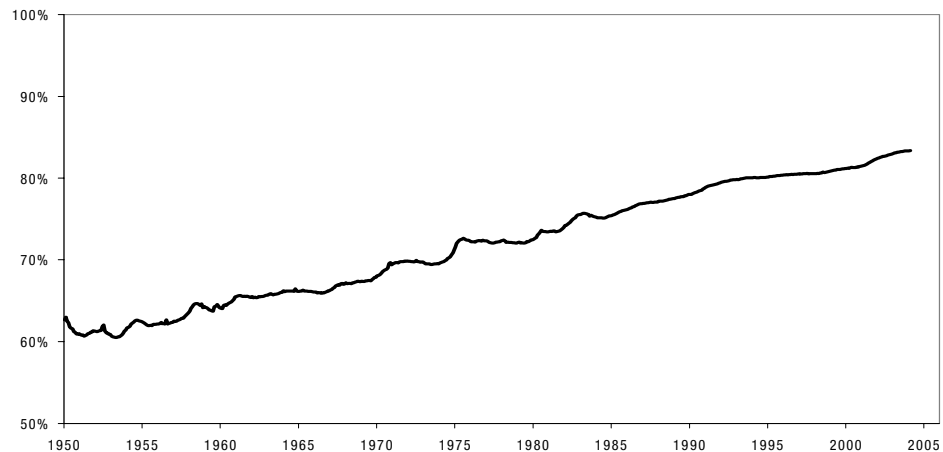
**Real consumption growth was never much below 2% in the recent recession, compared to actual declines in previous recessions.**

While the recession of 2001 brought an end to the American age of affluence, it is important to bear in mind just how strong the consumer sector remained during the downturn. Consider that real consumption growth was never much below 2% in the recent recession, compared to actual *declines* in previous recessions (see Figure 6). This was likely due, in large part, to the fact that the peak jobless rate (6.3% in June 2003) was well below the peaks reached in previous recessions (see Figure 7).

A key reason the consumer sector has remained relatively strong has likely been the muting of the business cycle. As noted previously, between 1950 and 1982, there were seven recessions, or one every 4.6 years. By contrast, since 1982, there have been just two recessions in 22 years. Three factors behind the “muted business cycle” have been:

- 1 *Low Inflation/Benign Deflation.* Declining technology costs have driven productivity gains, which help keep inflation low (see Figure 8) and thereby eliminate the need for extended periods of Fed tightening.
- 2 *A Service-Oriented Economy.* The structural shift away from manufacturing toward a service economy (see Figure 16) makes inventory accumulation difficult.

**Figure 16. Employment by Service Industries as a Percentage of Total Nonagricultural Employment**



Source: BLS

- 3 *Low Inventory Levels.* Networked computers have made lower inventory levels possible (see Figure 13). The power of information technology has enabled corporations to use information about stocks (and supply and demand) to keep inventories closely in line with sales, and thereby promote more steady growth by avoiding an inventory accumulation/decumulation cycle.

**In the 1990s, baby boomers probably became the most stressed generation in history.**

Despite the prosperity of the U.S. in the late 1990s, baby boomers probably became the most stressed generation in history. Boomers faced stress from the normal responsibilities of middle age (e.g., career, finances, and caring for children and elderly parents), with additional pressures coming from a sense of no job security and the urgent need to save for retirement. Then in the 21st century came the fear of terrorism.

## Stage 3: 2000–2020

### **Stable Misery; Aging**

To summarize, Stage 1 of the baby boomer lifecycle was characterized by 1) a boom-bust economy, 2) a high misery index, and 3) little real spending power. The key characteristics of Stage 2 were 1) a muted business cycle, 2) a falling misery index, and 3) peak earning years. As we argue below, Stage 3 is likely to be characterized by 1) low volatility of GDP, and, by definition, the components of GDP (including consumption and investment); 2) a stable misery index; and 3) an aging population that still has considerable spending power.

### **Low Volatility; A Stable Misery Index**

As we discussed above, the substantial decline in macroeconomic volatility has now become widely acknowledged in economic and academic circles. Whether macroeconomic volatility will continue to decline remains to be seen, and we are unwilling to prognosticate on that subject. However, barring some unforeseen exogenous shock, it seems unlikely that volatility will increase.

It seems likely that the misery index will remain stable, too. While inflation is likely to continue rising from the cyclical trough of 1.1% (on a year-over-year basis) reached in June 2002, it is hard to make a case for the kind of secular inflation that emerged in the late 1960s.

*A labor shortage is more of a risk in coming years than a glut of workers.*

As for unemployment, the combination of an aging labor force (albeit one in which participation rates continue to rise, as discussed below), slowing population growth, and stricter immigration policies suggest that a labor shortage is more of a risk in coming years than a glut of workers.

### **An Aging, but Still Affluent, Population**

As noted above, boomers are moving out of what, historically, have been their peak earning years. As Figure 15 illustrates, consumers aged 45–54 have, historically, been the top earnings group (earning 145% of the average), while the income of the 55–64 group has, historically, been just 120% of the average. *But there is good reason to believe these historical relationships may not hold true in the future.* Specifically, as we outline below, it is not implausible to argue that, in coming years, consumers aged 55–64 will earn as much as, if not more than, those aged 45–54.

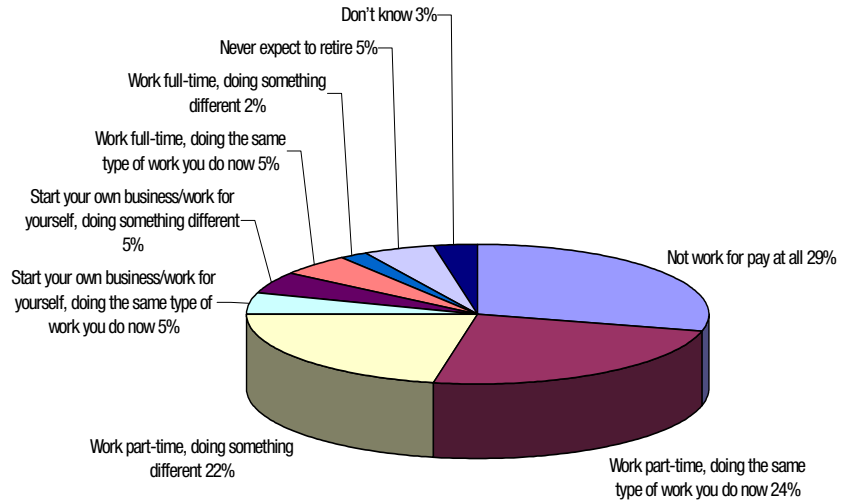
*In coming years, consumers aged 55–64 will likely earn as much as, if not more than, those aged 45–54.*

Unlike their parents who grew up amid the hardships of the Depression and World War II, baby boomers today do not view a leisurely retirement as their reward for years of hard work and sacrifice. Boomers have always been work centered and will likely remain so. Moreover, given that the typical American is living longer than ever before, many people are likely to choose the intellectual stimulation of work over the monotony of doing nothing.

A recent American Association of Retired Persons (AARP) study<sup>4</sup> revealed that nearly 70% of workers who have not yet retired say that they plan to work into their retirement years or never retire (see Figure 17).

**Figure 17. Plans for Retirement Among Workers Who Are Still Employed**

**Nearly 70% of workers who have not yet retired say they plan to work into their retirement years or never retire.**

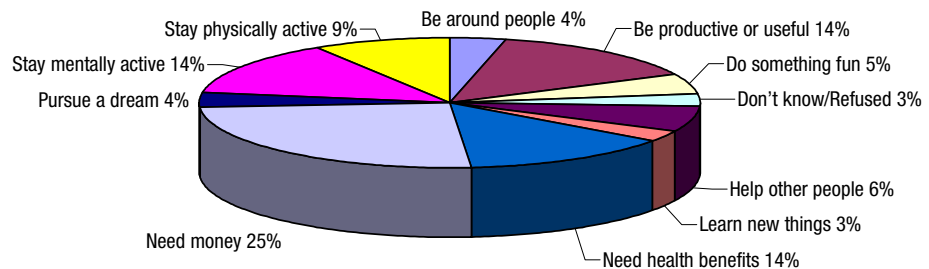


Source: American Association of Retired Persons (AARP)

Almost half indicated that they envision working into their 70s or beyond. (Those who may not want to work later in life could well be obliged to do so if reform of the Social Security system pushes back the retirement age.) Importantly, the AARP study found that the top motivations for working in retirement included not only the need for extra money, but also a general desire to work for enjoyment, to have something interesting to do, and to stay physically active (see Figure 18).

**Figure 18. Why Keep Working? Major Factors in the Decision to Work in Retirement**

**The top motivations for working in retirement included more than the need for extra money.**



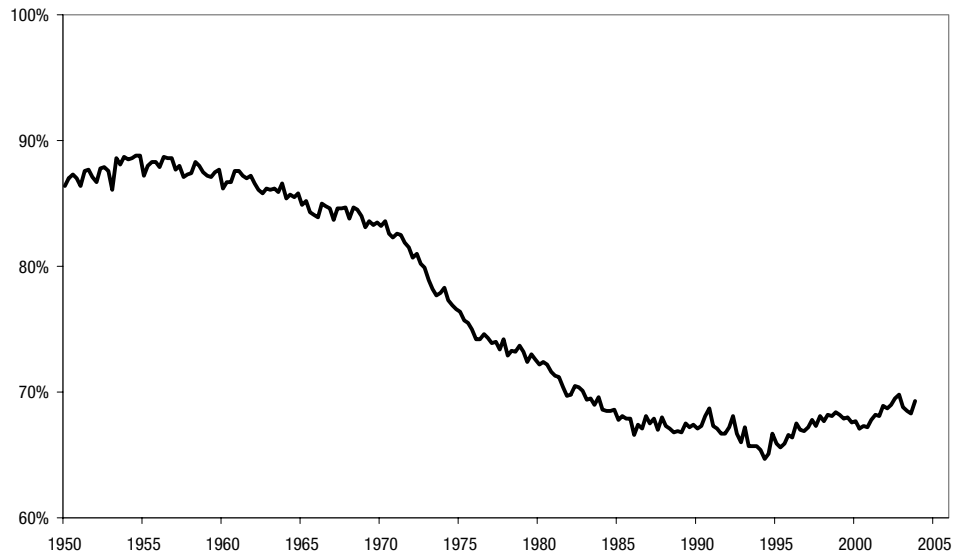
Source: AARP

<sup>4</sup> *Staying Ahead of the Curve 2003: The AARP Working In Retirement Study.*

This increasing desire to work is corroborated by rising participation rates for men aged 55–64 (see Figure 19). The labor force participation rate of men aged 65 and over has also started to climb (see Figure 20).

**Figure 19. Quarterly Labor Force Participation Rate of Men Aged 55–64, 1950–Present**

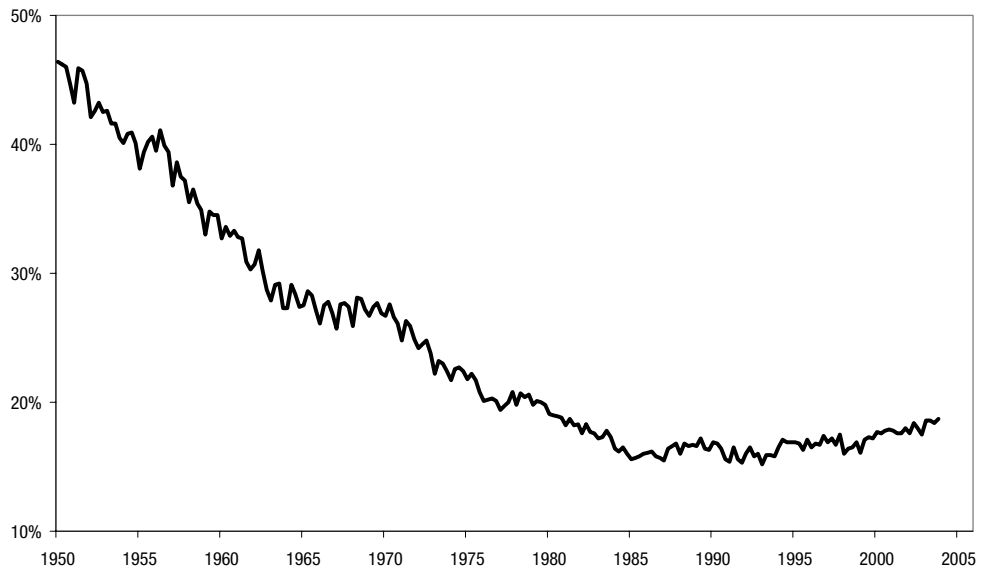
*The increasing desire to work is corroborated by rising participation rates for men aged 55-64...*



Source: BLS

**Figure 20. Quarterly Labor Force Participation Rate of Men Aged 65 and Over, 1950–Present**

*...and 65 and higher.*



Source: BLS

*Of the nation's workforce, 17% will be adults aged 55 and older by the year 2010, up from 13% in 2000.*

According to the BLS, 17% of the nation's workforce will consist of adults aged 55 and older by the year 2010, up from 13% in the year 2000. By 2050, older adults are projected to account for 19% of the workforce. During this period, younger workers between the ages of 25 and 54 are expected to decline as a percentage of the workforce to 67% in 2010 and 65% in 2050 from 71% in 2000.

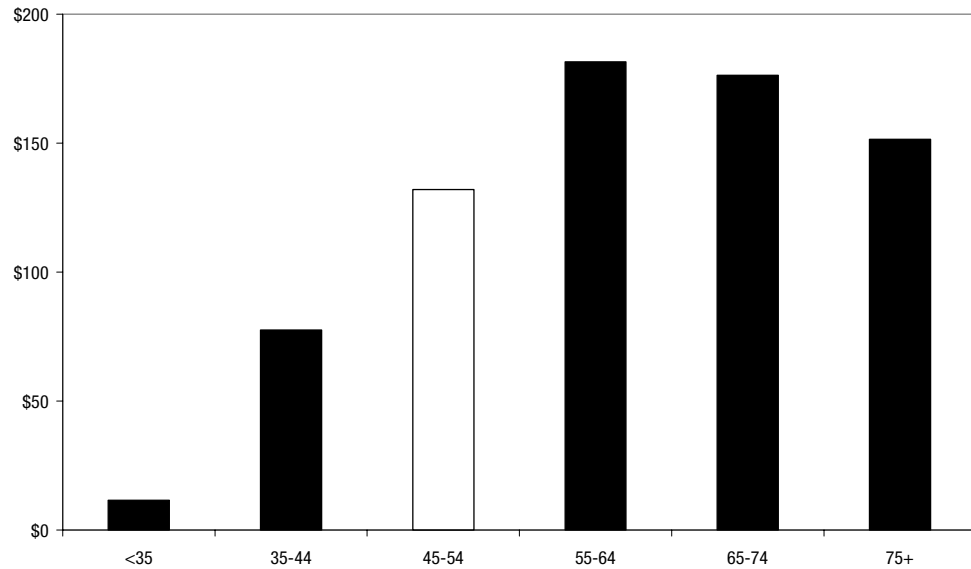
Because older workers have more experience than their younger counterparts, they are likely more productive and, therefore, more deserving of higher pay. Moreover, the real disposable incomes of *all* workers should be boosted by strong productivity growth driven by continued technological advances.

***The median net worth of the 45–54 age group is almost twice that of the 35–44 age group.***

Even if the annual *flow* of income to the older boomers does not match those of their younger counterparts, their total *stock* of wealth will likely be greater. Thanks to aggressive investing and a generally favorable investment environment, *boomers have accumulated significant wealth*. Figure 21 shows that, in 2001, the median net worth of people in the 45–54 age group was almost *twice* that of those in the 35–44 age group, with the median net worth of those aged 55–64 even higher. Moreover, inheritances will continue to be an important source of wealth as boomers inherit estates from their parents who prospered in the decades after World War II.

**Figure 21. Median Net Worth by Age of Head of Family**

Thousands of 2001 dollars



Source: Federal Reserve

# The Next American Dream

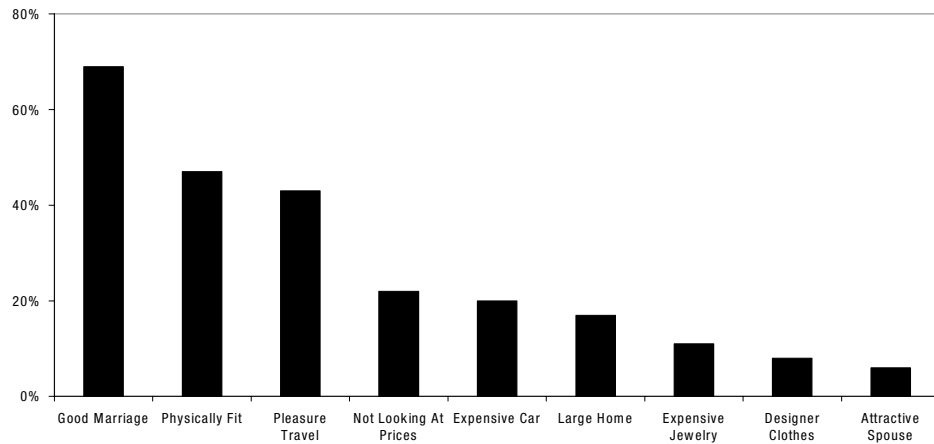
## What Will Drive the Aging, Affluent Boomer?

**Boomers place more value on experiences than on tangibles.**

A potent motivator for baby boomers has always been the desire for experiences, not just things. Today, with most of their material needs satisfied, boomers place more value on experiences than on tangibles. We highlight the following data points from the *Yankelovich MONITOR*:

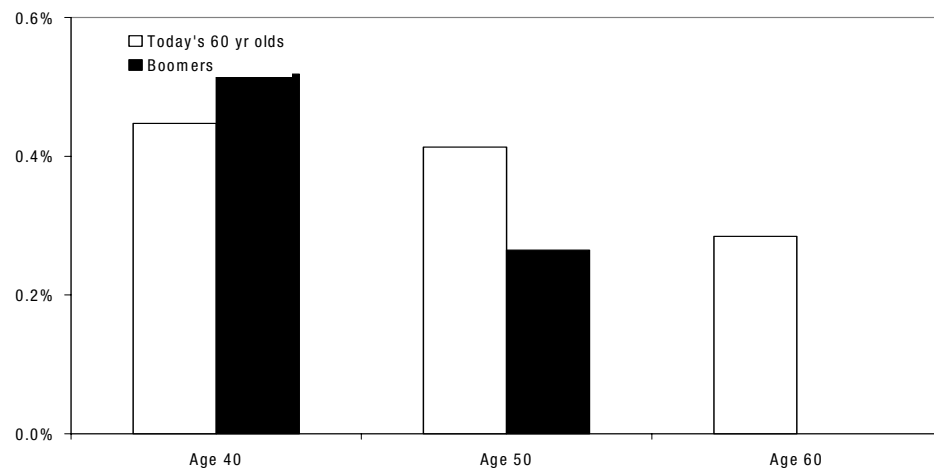
- Sixty-five percent of boomers say they need to satisfy their “hunger for new experiences.”
- When boomers were asked what they viewed as signs of success and accomplishment, the three bottom-ranked categories were an “extremely attractive spouse,” “designer clothes,” and “expensive jewelry” (Figure 22). Note that the amount of money spent on jewelry declines with age (Figure 23).

**Figure 22. Signs of Success and Accomplishment as Perceived by Boomers**



Source: Yankelovich Partners, Inc.

**Figure 23. Spending on Jewelry and Watches as a Percentage of Total Expenditures by Age**



Source: CES

- Although boomers feel a strong need for financial advice, as we discuss below, they are much less focused on money *per se*. The percentage of people aged 45–54 who agreed that money is “the only meaningful measure of success” dropped to only 16% in 2003 from 23% in 1994.

According to the *Yankelovich MONITOR* and the AARP, boomers are focused on:

- *Health* — 62% are concerned about trying to stay in shape.
- *Wealth* — 63% of boomers want to be able to afford the things that are important to them.
- *Activity* — Nearly 70% of workers who have not yet retired plan to work into their retirement years or never retire.

At the same time, however:

- Two in three boomers (65%) “feel guilty about not exercising more often.”
- Almost half (47%) say that “lately, I’ve become confused about the best way to invest my money.”
- More than half (54%) of boomers value “being able to take a day off when you want to.”

***We believe the gap between aspirations and reality is a key factor driving the behavior of baby boomers.***

*We believe this gap between aspirations and reality is a key factor driving the behavior of baby boomers.* As we discuss in detail below, the fact that boomers want to be fit yet are living unhealthy lifestyles has important implications for healthcare companies. The fact that cash- and asset-rich boomers want to plan their financial futures but are confused about how to invest their money is positive for selected financial services firms. And the fact that boomers value their free time but plan on working after retirement has implications for a variety of industries associated with leisure and entertainment.

Figure 24 is based on data from the CES and shows spending on major categories as a percentage of total expenditures by boomers aged 45–54 today and the cohort ahead of them (aged 55–64). In other words, the survey shows what the older cohort spent when they were in their 50s and what it is spending today now that they are in their 60s, versus what the 45–54 age group is spending now. So, for example, 31.7% of boomers’ spending today is on housing, which is already 2.3 percentage points higher than the 29.5% level of the older cohort when they were in their 50s. Spending by the older cohort on housing increased further as they moved from their 50s (29.5%) to their 60s (31.2%). Note that we discuss additional key data points from the CES in detail in subsequent sections.

**Figure 24. Spending by Boomers and Older Cohort on Major Categories, 1992 and 2002**

	Boomers		Older Cohort		Boomers vs. Older Cohort
	2002	2012	1992	2002	
	45-54	55-64	45-54	55-64	
	A	B	C	D	A-C
Housing	31.7%	?	29.5%	31.2%	2.3%
Transportation	18.8%	?	18.0%	19.1%	0.8%
Food	12.8%	?	14.0%	12.5%	-1.2%
Insurance and pensions	10.9%	?	11.4%	10.9%	-0.5%
Entertainment	5.3%	?	5.1%	5.2%	0.2%
Health care	5.2%	?	4.4%	6.8%	0.8%
Apparel	4.2%	?	6.0%	4.0%	-1.8%
Alimony, child support	3.2%	?	3.2%	3.4%	0.0%
Education	2.5%	?	2.2%	1.3%	0.3%
Personal care	1.2%	?	1.3%	1.3%	-0.1%
Alcoholic beverages	1.0%	?	0.8%	0.9%	0.2%
Tobacco products	0.9%	?	1.0%	0.8%	-0.2%
Reading	0.3%	?	0.5%	0.4%	-0.2%

Source: CES

Of course, we are ultimately trying to predict the likely contents of column B — that is, what the breakdown of spending by today’s 45- to 54-year-old boomers will be as they age over the next decade. To that end, we have carefully scrutinized the CES data, consulted with Yankelovich Partners, and interviewed key Smith Barney industry analysts. Our conclusions are discussed in subsequent sections.

***It seems likely that stable demand by older boomers will coincide with an extended period of low economic volatility.***

Importantly, as we outlined above, it seems likely that stable demand by older boomers will coincide with an extended period of low economic volatility (a.k.a. “The Great Moderation”). The challenge, then, for investors will be to identify the stocks and sectors that should benefit from strong *demand* by aging boomers *and also* enjoy resilient pricing thanks to a favorable *supply* environment. Figure 1 summarizes how various industries are positioned to benefit from these supply and demand variables. Figure 25 lists companies that seem particularly well positioned.

**Figure 25. Companies That Appear Well Positioned to Benefit from the Next American Dream**

<b>Healthy</b>	Allergan Pharmaceuticals (AGN)	Estee Lauder (EL)
	Amgen (AMGN)	Genentech (DNA)
	Anthem (ATH)	NBTY (NTY)
	Applebee's International (APPB)	Procter & Gamble (PG)
	Avon Products (AVP)	Robert Mondavi (MOND)
	BJ's Wholesale Club (BJ)	Ruby Tuesday (RI)
	Brown-Forman (BFA)	UnitedHealth Group (UNH)
	Constellation Brands (STZ)	Weight Watchers (WTW)
	Darden Restaurants (DRI)	WellPoint Health Networks (WLP)
	Endo Pharmaceuticals (ENDP)	
<b>Wealthy</b>	Charles Schwab (SCH)	Merrill Lynch (MER)
	Hartford Financial (HIG)	Prudential Financial (PRU)
	Lincoln National (LNC)	T. Rowe Price (TROW)
<b>Active</b>	Carnival Corp (CCL)	Mandalay Resort Group (MBG)
	Coach (COH)	Masco Corporation (MAS)
	Fairmont Hotels (FHR)	Neiman Marcus (NMGA)
	Four Seasons Hotels (FS)	PETCO Animal Supplies (PETC)
	GTECH Holdings (GTK)	Petsmart (PETM)
	Harman International (HAR)	Pulte Corp (PHM)
	Home Depot (HD)	Royal Caribbean Cruises (RCL)
	International Game Technology (IGT)	Starwood Hotels (HOT)
	Lowe's (LOW)	Toll Brothers (TOL)
	Magna International (MGA)	Williams-Sonoma (WSM)

Source: Smith Barney

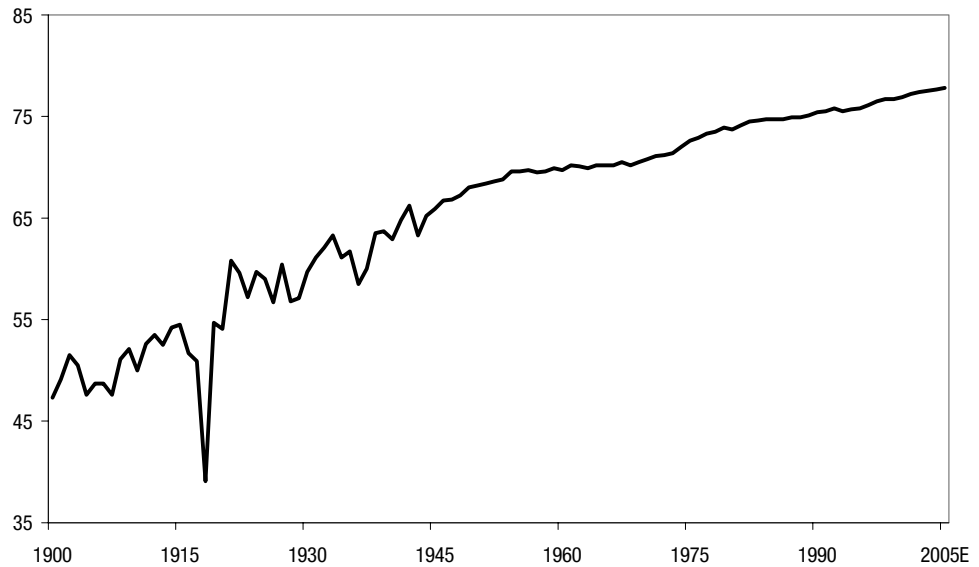
# Healthy

## Having Your Cake (and French Fries and Chips) and Eating It, Too

*During the past 20 years, there has been a dramatic increase in obesity in the United States.*

Boomers may be living (see Figure 26) and working longer, but they are not staying healthier. Most notably, during the past 20 years, there has been a dramatic increase in obesity in the United States. (Obesity is defined as having a very high amount of body fat in relation to lean body mass.)

**Figure 26. American Life Expectancy in Years, 1900–2005E**

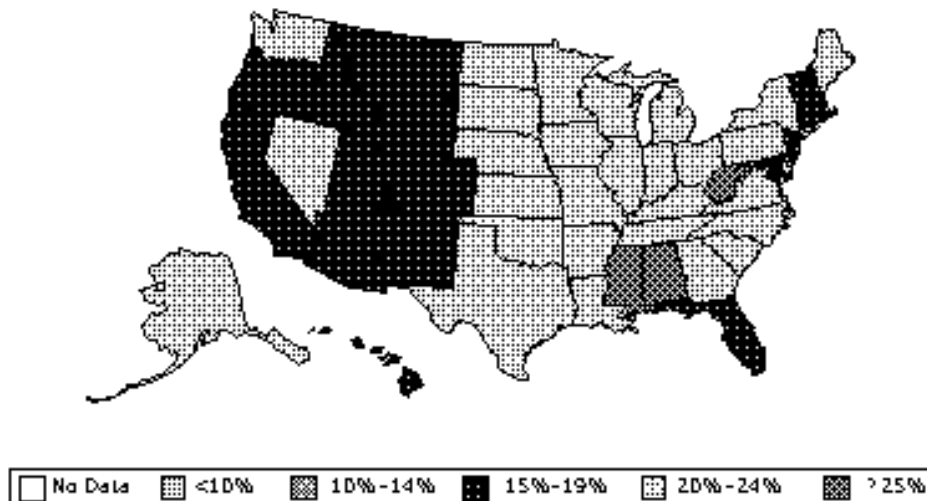


Source: Statistical Abstract

*More than one in four boomers aged 50–59 are overweight.*

In 2002, 18 states had obesity prevalence rates of 15%–19%; 28 states had rates greater than or equal to 20%; and three states — Alabama, Mississippi, and West Virginia — reported a rate over 25% (see Figure 27). The most obese segment of the population in 2001 was people aged 50–59, with more than one in four boomers in this category being overweight (see Figure 28). (Note also that the average woman wore a size 8 in 1990 and wears a size 14 today, which is equivalent to size 18 in 1990 terms.)

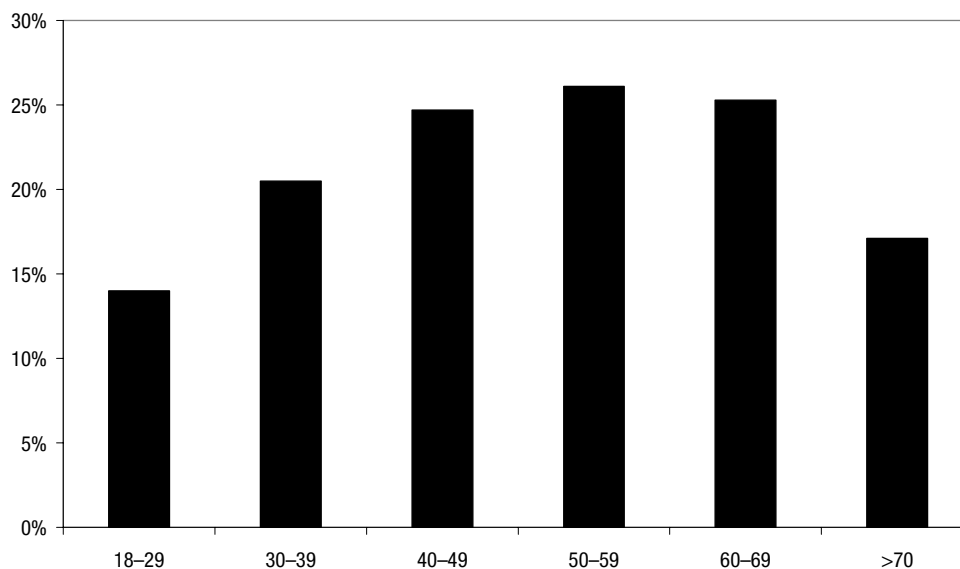
**Figure 27. Obesity\* Trends Among U.S. Adults in 2002**



\* About 30 lbs overweight for a 5' 4" person.

Source: Centers for Disease Control

**Figure 28. Obesity by Age Group in 2001**



Source: Centers for Disease Control

**Boomers today are much more concerned about their health than the cohort ahead of them was in 1994 when they were in their 50s.**

Although Americans have always been interested in health issues, boomers today are *much more* concerned about their health than the cohort ahead of them was back in 1994 when they were in their 50s:

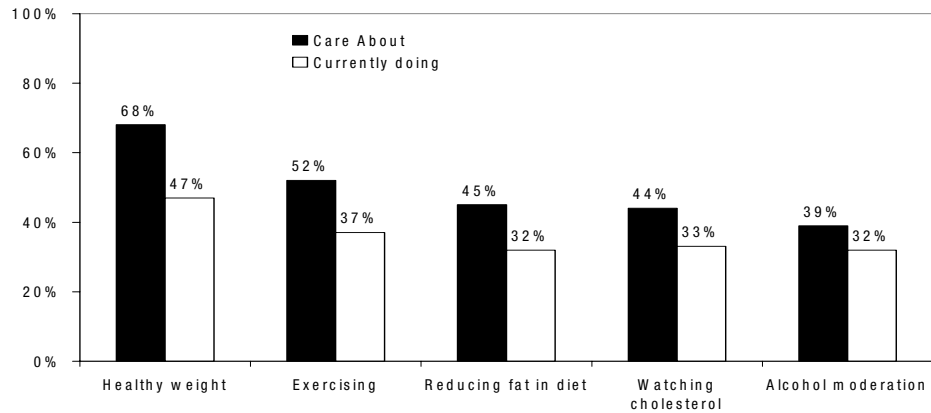
- The percentage of people aged 45–54 who were “concerned about trying to stay in shape” was 37% in 1994 but 60% in 2003.
- The percentage of people aged 45–54 who were “concerned about trying to take care of myself” was 40% in 1994 but 57% in 2003.

However, at the same time, boomers effectively admit that they are living an unhealthy lifestyle:

**Boomers say that they “care about” various health-related activities, but a smaller percentage say that they are “currently doing” something.**

- ▶ While a large percentage of boomers say that they “care about” various health-related activities, in each case, a much smaller percentage say that they are “currently doing” something about those activities (see Figure 29).

**Figure 29. Health-Related Activities That Boomers “Care About” vs. “Currently Doing”**



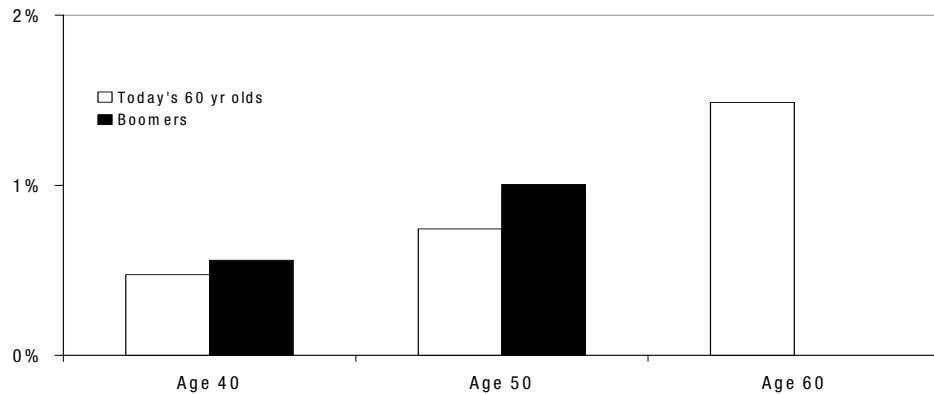
Source: Yankelovich Partners, Inc.

**Boomers do not overwhelmingly blame the obesity epidemic on the food and beverage industry.**

- ▶ Boomers do not overwhelmingly blame the obesity epidemic on the food and beverage industry. When asked whether “the food and beverage industry should take more responsibility for the obesity problems in America,” 46% of boomers agreed, while 53% disagreed. It seems that boomers realize that they have only themselves to blame for their own obesity — seven in ten (71%) agree that “food is an important sense of pleasure in my life.”
- ▶ Only two in five boomers (39%) say they “avoid buying foods that are not nutritious or good for me even if I like them.”
- ▶ Only one in ten boomers (12%) say they have attained their goal of “adopting a healthy lifestyle.”

So many boomers find themselves in the paradoxical situation of living an unhealthy lifestyle *and* taking a handful of drugs to remain active (see Figure 30).

**Figure 30. Spending on Drugs as a Percentage of Total Expenditures by Age**



Source: CES

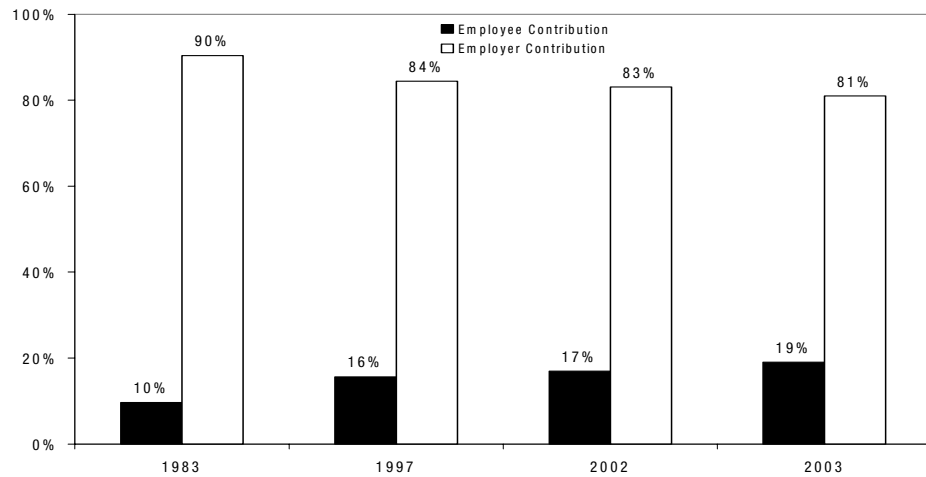
Drug consumption has also been spurred by the fact that drugs are:

- *Cheap.* Many employers offer health care programs with prescription drug plans, under which participants pay a low (\$15–\$20) co-payment for a 30-day supply of pills. Indeed, 94% of boomers who have health insurance participate in a plan that includes prescription drug coverage.
- *Convenient.* Many doctors in managed care systems are under pressure to see as many patients as possible, and prescribing a drug is often the quickest way to treat a patient. Forty percent of boomers say that “my doctor or health care provider does not spend enough time with me.”
- *Cost effective.* With heavy emphasis today on managing health care costs, in many instances drugs are the most cost-effective treatment for patients. For example, taking a painkiller is much less expensive than back surgery.

***With health care accounting for just 5% of boomers’ expenditures, many employers believe households are able to pay more for medical coverage.***

However, the growth in consumption of drugs (as well as other medical products and services) may be about to slow sharply, in large part as employers seek to further push rising health care costs onto employees. With health care accounting for just 5% of boomers’ expenditures (see Figure 24), many employers believe there is still plenty of room for households to pay more for medical coverage.

**Figure 31. Employer and Employee Contribution to Monthly Health Insurance Premium\*, 1983–2003**



\* Based on single coverage.

Source: BLS, Hewitt Associates, Towers Perrin, and Smith Barney

***HSAs will likely have profound implications on health care consumption.***

The catalyst for employees paying more could well be the “Medicare Prescription Drug, Improvement, and Modernization Act” of 2003, which goes beyond assisting seniors with prescription drugs, and contains many other provisions that have wide-ranging implications for the entire health care industry. Note that implementation of most of the law does not happen until 2006 or later, and many of the requisite details are not yet final because rules will not be written for another year or two. One key provision of the Act, the establishment of Health Savings Accounts (HSAs), has nothing to do with Medicare, and will likely have profound implications for health care consumption.

In effect, an HSA is to health care what a 401(k) is to retirement savings:

- An HSA is a tax-efficient way for individuals to save money for health care-related expenses.
- It would be packaged with high deductible/catastrophic health insurance coverage.
- It would be a much less expensive option than buying a typical health insurance policy today. For example, instead of paying \$5,000 per year for health insurance, an employee might pay \$2,000 per year for catastrophic coverage, put \$2,250 tax-free in an HSA, and pocket the \$750 difference.

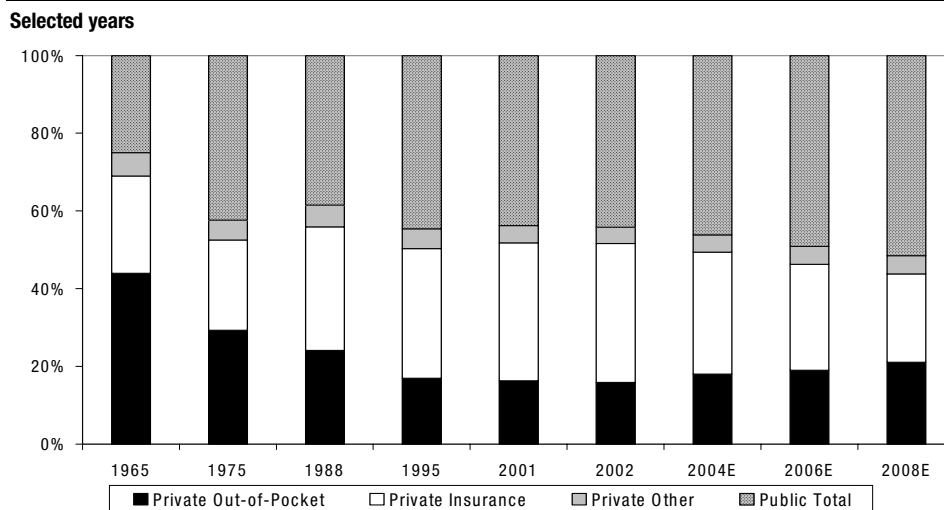
***HSA's should be very profitable to first movers that have both the scale and the technology to grab share in a rapidly expanding market.***

While the introduction of HSAs will likely be negative for the health insurance industry's profitability, in the long run (given that it is a low-revenue product), it should be very profitable to the first movers that have both the scale and the technology to grab share in a rapidly expanding market. Likely beneficiaries would include *Anthem, UnitedHealth Group, and WellPoint Health Networks.*

For employees, however, HSAs raise a number of key issues:

- In an environment of rapidly rising health care costs, HSAs give employers a door to discontinue health care as an employee benefit. In other words, many employees could be "forced" into HSAs.
- Based on employee behavior with respect to 401(k) contributions and withdrawals during the recent economic downturn, there are grounds for concern that employees would not put nearly as much money into their own health insurance as employers put in for them.
- Spending on prescription drugs and other non-urgent care would likely drop significantly under HSAs because patients would see the money coming directly out of their own pockets (see Figure 32).

**Figure 32. Health Expenditures by Public, Private, and Out-of-Pocket Payors, 1965–2008E**



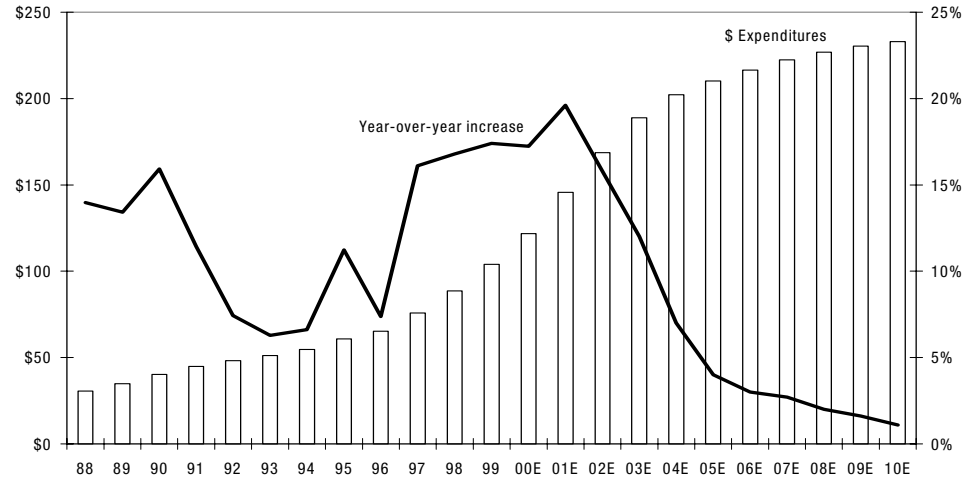
Source: Centers for Medicare and Medicaid Services, Office of the Actuary, National Health Statistics Group, and Smith Barney

It seems likely that participation rates for health coverage could decline in any switch to a defined contribution from a defined benefit plan. Defined benefit plans, by definition, have nearly 100% participation rates since there is no cost to the employee. Data from the Federal Reserve’s 2001 Survey of Consumer Finances (SCF) showed that about 26% of workers eligible to participate in a 401(k) plan chose not to do so.<sup>5</sup>

Partly because of these factors, drug-spending growth is forecast to slow in 2004–10 (see Figure 33).

**Drug spending growth is forecast to slow in 2004–10.**

**Figure 33. Pharmacy Spending and Year-Over-Year Percentage Increases, 1988–2010E**



Source: Centers for Medicare and Medicaid Services, Milliman USA, American Association of Health Plans, KPMG, and Smith Barney

**It is likely that consumers are willing to pay for drugs that have an immediately perceptible effect.**

A key issue, of course, is what consumers consider to be “non-urgent” health care. It is likely that consumers will be willing to pay for drugs that have an immediately perceptible effect (e.g., for sexual dysfunction), but not for drugs whose results are not that apparent (e.g., for cholesterol). Other “lifestyle drugs” that employees would likely be willing to pay for include Botox, the wrinkle remover manufactured by *Allergan Pharmaceuticals* (Not Rated).

Note that as Figure 34 illustrates, Botox injections were by far the most popular cosmetic procedure in 2003. Moreover, as Figure 35 illustrates, boomers in the 35–50 age group accounted for more than half (55%) of those injections, with Americans aged 51–64 accounting for another 26%.

<sup>5</sup> *Suspending the Employer 401(k) Match*, Alicia H. Munnell and Annika Sunden, Center for Retirement Research at Boston College.

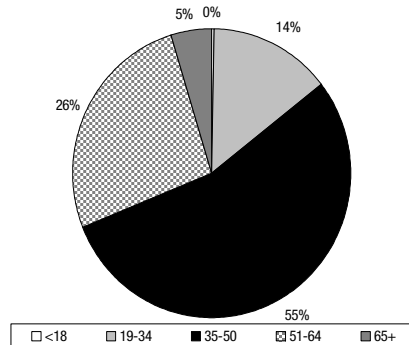
**Figure 34. National Totals for Cosmetic Procedures**

In millions



Source: American Society for Aesthetic Plastic Surgery

**Figure 35. Botox Injections by Age Group in 2003**



Source: American Society for Aesthetic Plastic Surgery

**Beauty care is one of P&G's fastest-growing businesses on a global basis.**

Botox helps people look (and, hopefully, feel) younger. Of course, many personal care products are marketed with the same promise. For example, *Procter & Gamble's* Olay Regenerist skin care products claim to address the “seven stages of aging” through a patented amino-peptide complex that helps to hydrate and condition skin. Thanks to products such as Regenerist, beauty care is one of Procter & Gamble’s fastest-growing businesses on a global basis.

Other personal care companies are also focused on addressing the skin care needs of baby boomers. For example, *Avon Products' Anew* skin care line boasts an assortment of products for anti-aging needs, including the newest Anew Clinical product, which is specifically designed to fight aging lines and wrinkles. In addition, at the super-premium end, *Estée Lauder* offers its Perfectionist and Idealist products to help refine aging skin.

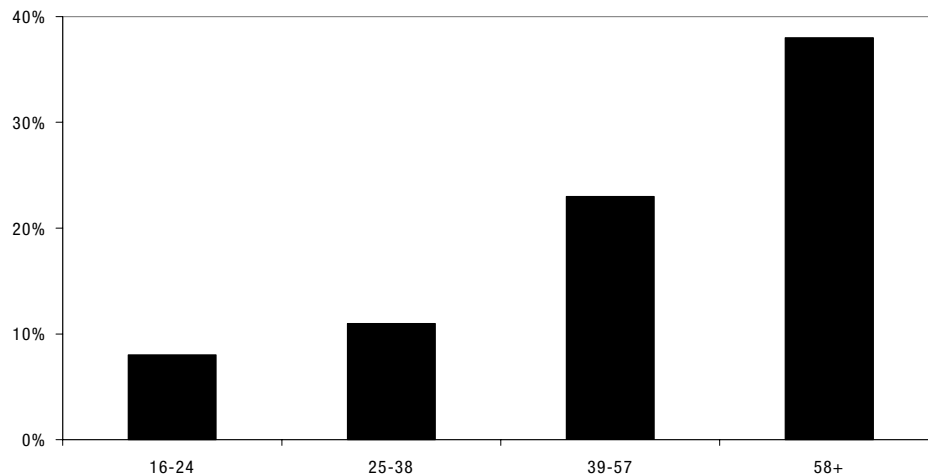
Beyond personal care, while Procter & Gamble’s pharmaceuticals business is still relatively small (representing less than 4% of company sales), it is also growing rapidly, thanks in large part to products that target middle-aged women, e.g., Actonel for bone-density loss and Intrinsic, which is in Phase III testing to help improve postmenopausal libido.

**Alleviating pain is most patients' top priority.**

Of course, alleviating pain is most patients’ top priority, and pain is being treated much more aggressively than in the past, which is positive for *Endo Pharmaceuticals* (Not Rated), a leader in pain management medications. Not surprisingly, managing arthritis pain becomes more important with age (see Figure 36).

**Figure 36. Health-Related Activities Americans Care About: Managing Arthritis Pain**

Percentage agreeing by age group



Source: Yankelovich Partners, Inc.

***In general, big pharmaceutical companies seem likely to be squeezed by a weakening in demand and an increased supply of products.***

In general, big pharmaceutical companies seem likely to be squeezed from both sides — a weakening in demand and an increased supply of products. First, in terms of supply, re-imported drugs from overseas (mainly Canada and Mexico) will likely continue to seep into the U.S. market. In 2003, 5% of boomers said that they had purchased prescription medication outside the U.S. in order to save money. Second, competition from generic manufacturers is likely to become even more intense. Not only are the generic manufacturers challenging a growing number of patents in court but, thanks in large part to technological advances overseas, their manufacturing processes are becoming increasingly sophisticated, which facilitates the replication of complex medications.

While the large pharmaceutical companies seem threatened by a host of issues, selected generic manufacturers seem well positioned for the following reasons:

***Given the low prices of generics, re-importation is not an issue.***

- Generic drugs, by definition, are relatively inexpensive, which appeals to cash-strapped consumers and budget-conscious corporations.
- Given the low prices of generics, re-importation is not an issue.
- In contrast to many seniors, a large number of whom remain suspicious of generics in the wake of scandals during the 1990s, today’s boomers are comfortable taking the generic version of a medication. Sixty-three percent of boomers prefer generic prescription medication to brand-name prescription medication, versus 58% of people in the “mature” 58-plus age group.

***Sixty-three percent of boomers prefer generic prescription medication to brand-name prescription medication.***

Generic drug manufacturers with large portfolios seem well positioned to benefit from these trends. Procter & Gamble also seems well positioned given its experience in managing the transition as drugs move from prescription to over the counter (OTC). For example, in September 2003, the company introduced Prilosec OTC and is on target to generate roughly \$400 million in retail sales in year one.

**Biotech companies are less susceptible to the threat of generic competition.**

Selected biotech companies also seem well positioned to benefit from health care reform for three reasons. First, biotech companies are currently less susceptible to the threat of generic competition. Although discussions are under way regarding the potential for a streamlined regulatory process for biogenerics in the U.S. and Europe, it is likely that the complexities of manufacturing biologics will make it difficult to establish bioequivalency guidelines that ensure the safety and efficacy of biogenerics compared to the branded biologics.

Second, recall that HSAs would be packaged with high deductible/catastrophic health insurance coverage. The typical indications targeted by biotech companies involve severe or advanced diseases that are more likely to be covered by catastrophic health insurance coverage. Moreover, although biotech products are typically very expensive, the fact that they are prescribed to a relatively small number of patients who may also have a limited life span makes it less of an issue for insurance companies to cover the cost.

Third, as part of the drug benefit in the Medicare Reform Bill, seniors will pay:

- A \$35 premium per month;
- A \$250 annual deductible;
- 25% of the costs between \$250 and \$2,250;
- 100% of the costs between \$2,250 and \$5,100; and
- 5% of all costs above \$5,100.

**The government will cover 95% of the price of drugs that cost more than \$5,100.**

In other words, the government will be covering 95% of the price of drugs that cost more than \$5,100, which can easily be the annual cost of a single biotech drug.

Diseases that many boomers are susceptible to include:

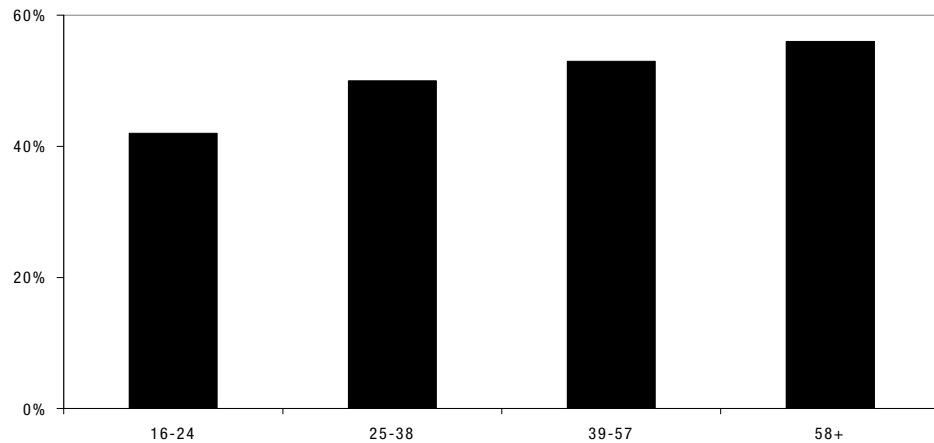
- *Cancer.* Biotech company *Genentech* is at the forefront of a new generation of cancer treatments involving targeted therapeutics and monoclonal antibodies. This approach allows for a more precise treatment that may result in improved efficacy and safety compared to existing therapies, such as traditional chemotherapies. The company recently launched a novel therapy called Avastin for the treatment of colorectal cancer. Genentech has demonstrated the ability to provide a significant survival benefit in patients receiving Avastin in combination with certain chemotherapy regimens as a first-line treatment for metastatic colorectal cancer.
- *Arthritis.* As we have noted, arthritis is an issue for aging boomers. *Amgen's* Enbrel is used in the treatment of rheumatoid arthritis and psoriatic arthritis. In the opinion of Smith Barney biotech analyst Elise Wang, Enbrel has the most compelling efficacy, safety, and ease-of-use profile among the biologics for these diseases, and offers a potentially safer and more efficacious treatment than current therapies such as methotrexate and cyclosporine.
- *Osteoporosis.* Amgen currently has a drug called AMG 162 in Phase II trials for the treatment of osteoporosis. In comparison to Merck's Fosamax, this drug appears to have the potential to be more effective, with a highly convenient

dosing regimen consisting of an injection every six months compared to a weekly oral dose of Fosamax. Fosamax also has potential gastrointestinal side effects and restrictive dosing requirements.

Finally, note that, in addition to taking drugs, boomers are also taking vitamins; the propensity to take vitamins increases with age (see Figure 37). In the U.S., *NBTY* sells roughly 1,000 vitamin, mineral, and supplement (VMS) products through Vitamin World, a retailer, and Nature’s Bounty, its VMS wholesale segment.

*The propensity to take vitamins increases with age.*

**Figure 37. Health-Related Activities Americans Care About: Taking Vitamins**



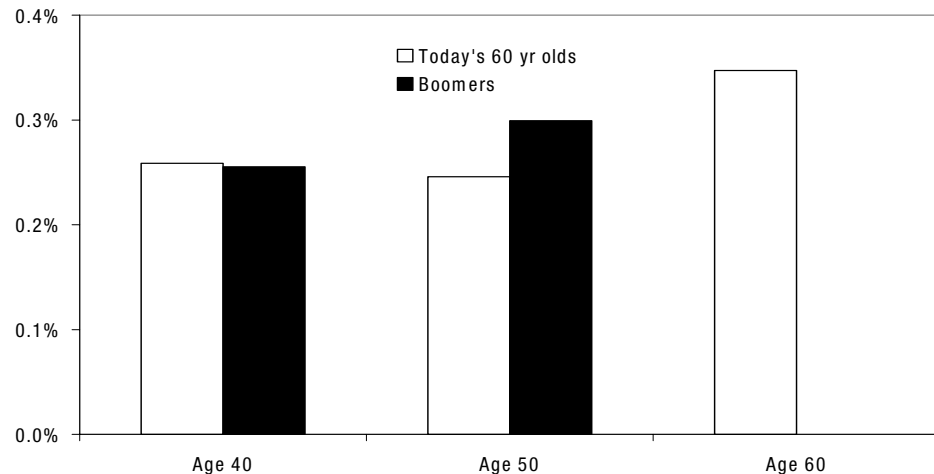
Source: Yankelovich Partners, Inc

### Eating Healthy

*The consumption of fish and seafood increases as people age.*

The recent popularity of the Atkins diet shows that many Americans, including boomers, are trying to “eat healthy.” Whether or not the Atkins fad continues (most fads do not), eating patterns typically change as people age. For example, as Figure 38 illustrates, the consumption of fish and seafood increases as people age (with today’s boomers spending more on fish than 50-year-olds did ten years ago). If the trend toward higher seafood consumption were to continue, one beneficiary could be *Darden Restaurants*, the owner of the Red Lobster chain.

**Figure 38. Spending on Fish and Seafood as a Percentage of Total Expenditures by Age**



Source: CES

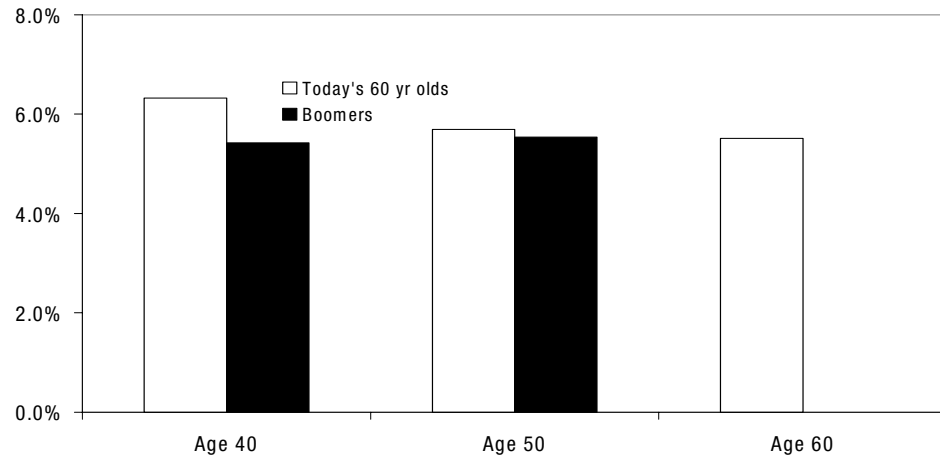
**Spending on “food away from home” by today’s boomers has been increasing.**

Another key trend with regard to eating habits is that total spending on “food away from home” by today’s boomers has been *increasing* in contrast to the pattern of the generation ahead of them, which steadily cut back spending on eating out (see Figure 39). Given that “food away from home” includes fast-food restaurants, which older people are less likely to frequent (see Figure 40), and upscale restaurants, which, *in the past*, many older people have been unable to afford, it is not surprising that spending on eating out has typically trended down as people age. But with boomers today staying in the labor force longer, it is likely they can *afford* to eat out in casual and upscale restaurants, and also *want to* eat out to save time and add some variety to their lives.

**Low-Carb Trend: Bearish for Bread**

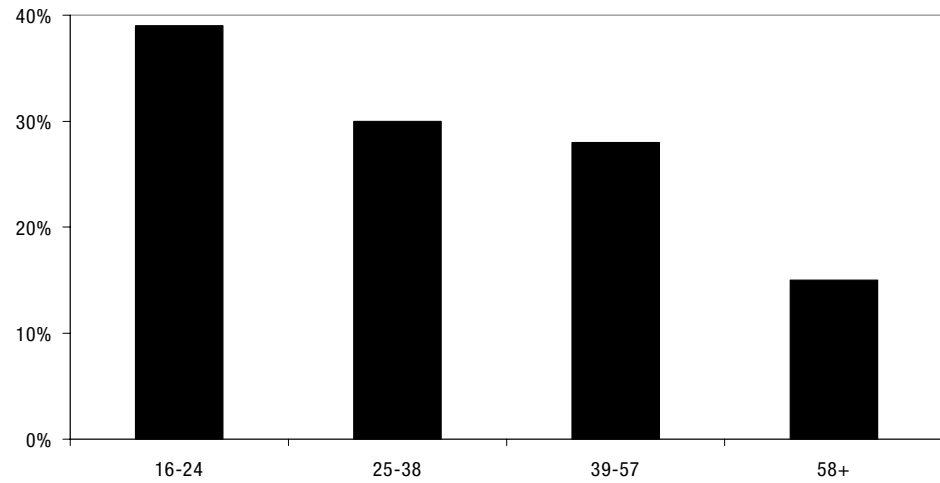
Spending on bread, which typically declines as people age, is relatively low today (see Figure 41), which again could suggest the influence of a high protein diet on boomers’ consumption. Should interest in the Atkins diet continue, the downward trend for bread would likely be further reinforced. (Note that, following a sales decline, Interstate Bakeries Corp. [Not Rated] recently suspended its dividend, perhaps yet more evidence that diets such as Atkins and South Beach have led to lower consumption of foods high in carbohydrates, including bread, in the United States.)

**Figure 39. Spending on Food Away from Home as a Percentage of Total Expenditures by Age**



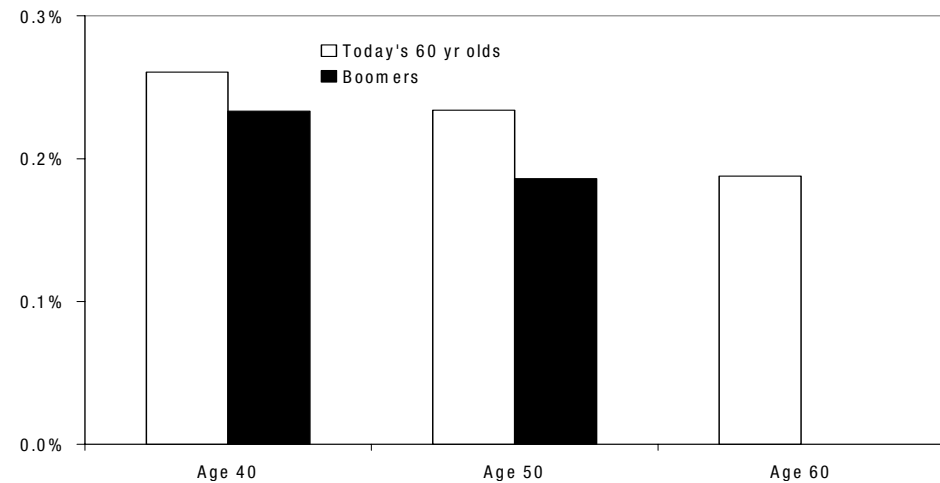
Source: CES

**Figure 40. "I Eat Fast Food a Few Times a Week" (Percentage Agreeing by Age Group)**



Source: Yankelovich Partners, Inc

**Figure 41. Spending on Bread as a Percentage of Total Expenditures by Age**



Source: CES

***Restaurants that pay special attention to calories and cholesterol appear well positioned.***

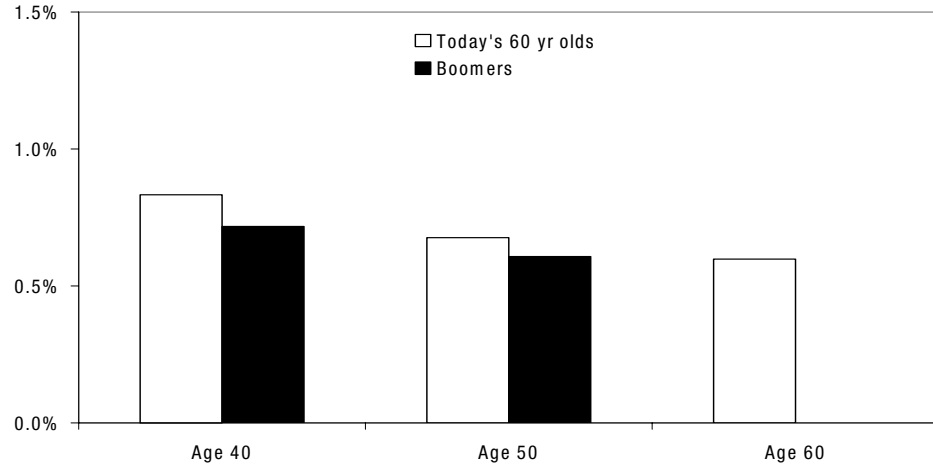
Even if boomers do not actually eat healthily, companies that pay special attention to calories and cholesterol appear well positioned. *Applebees* (Not Rated) has begun to list *Weight Watchers*' "points" on its menus, and *Ruby Tuesday* (Not Rated) lists the calorie content of servings on its menus.

In terms of where boomers buy their food and household products, *BJ's Wholesale Club* uses its database of customers' shopping habits to send customized direct mail to target groups, including boomers. For example, recognizing that many boomers are empty nesters, BJ's may emphasize in a mailing the value proposition of its products. More specifically, BJ's "Life Size" packaging is more moderately sized relative to that of other warehouse clubs, but offers a better value than is found in supermarkets.

***As people age, they consume fewer soft drinks and more alcoholic beverages.***

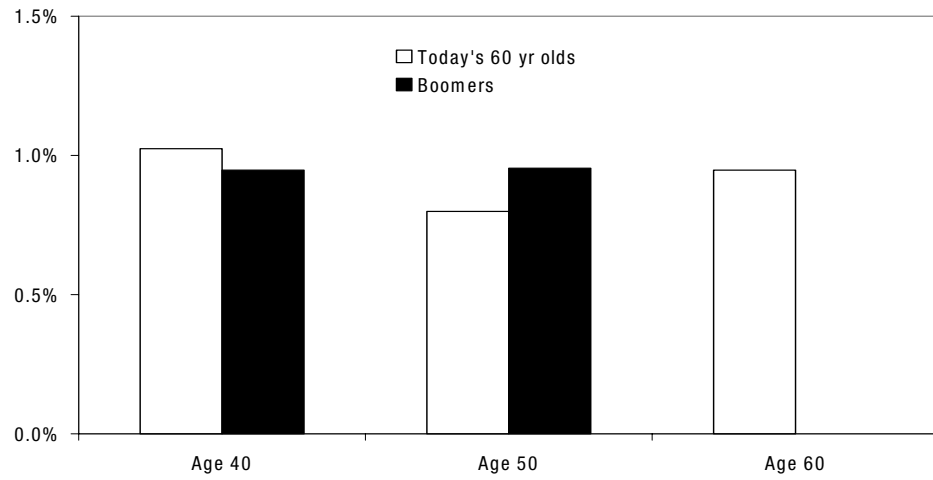
As for what they drink, as people age, they consume fewer soft drinks (see Figure 42) and more alcoholic beverages (see Figure 43). Here, too, it is the case that the change in consumption patterns of boomers is much more dramatic than that of the cohort ahead of them — boomers are drinking much *less* soda and much *more* alcohol. One possible reason for this is heightened stress levels — the propensity to consume alcohol as a way to relieve stress increases with age (see Figure 44).

**Figure 42. Spending on Nonalcoholic Beverages as a Percentage of Total Expenditures by Age**



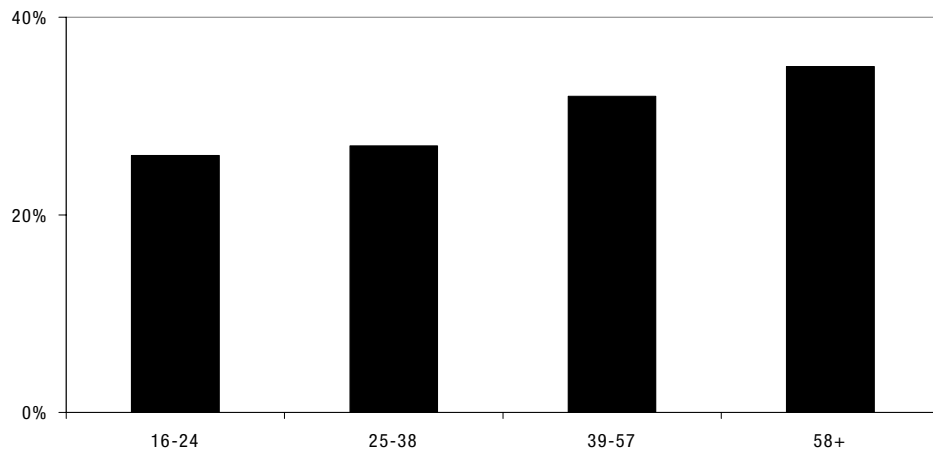
Source: CES

**Figure 43. Spending on Alcoholic Beverages as a Percentage of Total Expenditures by Age**



Source: CES

**Figure 44. Having a Drink as a Way of Relieving Stress (Percentage Agreeing by Age Group)**



Source: Yankelovich Partners, Inc.

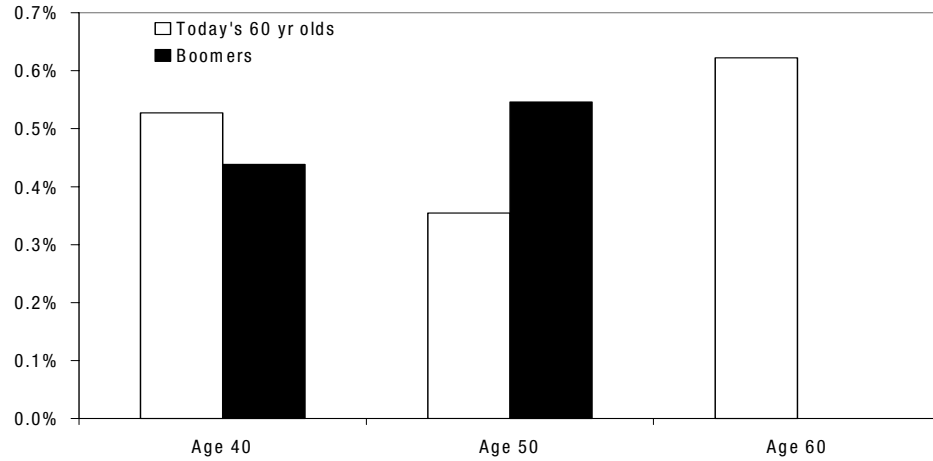
***Boomers are drinking wine and liquor rather than beer.***

In terms of alcohol consumption, as one might expect, boomers are drinking more wine and liquor (see Figure 45) than beer (see Figure 46). Likely beneficiaries of this trend include spirits manufacturer *Brown-Forman* (Not Rated), wine and spirits manufacturer *Constellation Brands*, and wine producer *Robert Mondavi* (Not Rated).

***The typical pattern is for spending on tobacco to decline as people enter their 60s.***

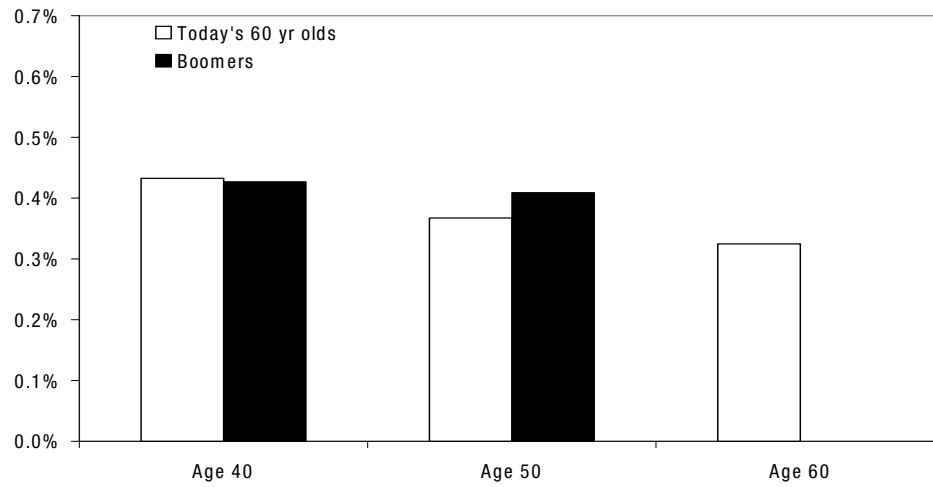
Of course, it is widely known that smoking is unhealthy. As Figure 47 illustrates, like the cohort ahead of them, boomers in their 50s are spending just about as much on tobacco products as they did in their 40s. This spending typically declines as people enter their 60s.

**Figure 45. Spending on Wine and Liquor as a Percentage of Total Expenditures by Age**



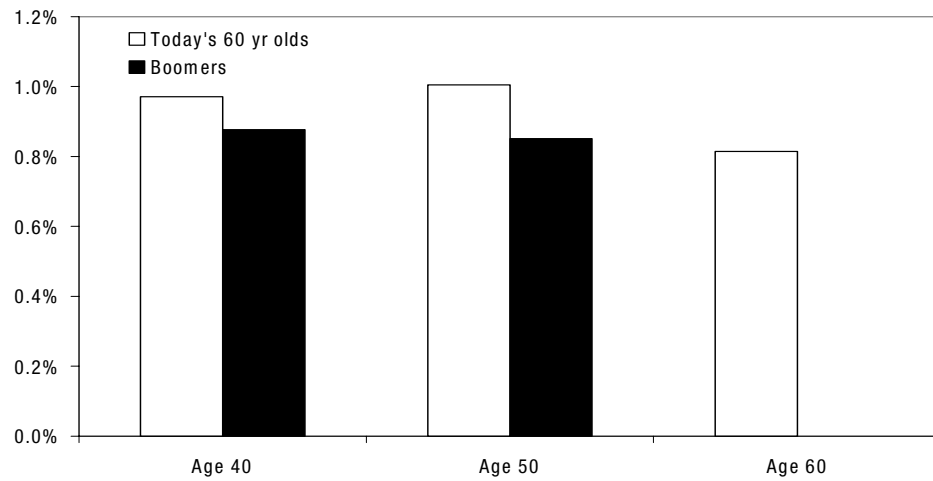
Source: CES

**Figure 46. Spending on Beer as a Percentage of Total Expenditures by Age**



Source: CES

**Figure 47. Spending on Tobacco as a Percentage of Total Expenditures by Age**



Source: CES

# Wealthy

## Have Money, Need Advice

Because the Consumer Expenditure Survey (CES) collects data on income as well as expenditures, we can compute a savings rate for all consumers and specific age groups if we define the savings rate as:

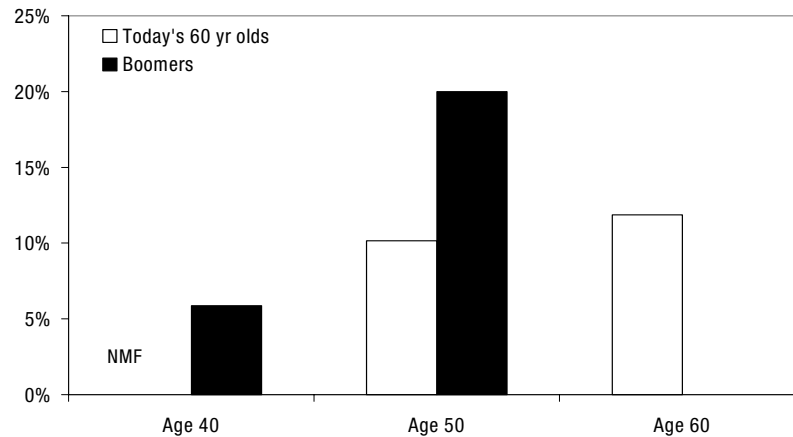
$$\frac{\text{Income after taxes} - \text{Average annual expenditures}}{\text{Income after taxes}}$$

While the CES states that it has confidence in the consumption data, it acknowledges a problem with “the underreporting of income by respondents, a problem common to most household surveys.” According to the CES, this problem applies primarily to lower income groups. But the usefulness of the CES data is that it allows us to compute a savings rate for specific age groups.

**Baby boomers saved double the savings rate of today’s 60-year-olds when they were in their 50s.**

As Figure 48 illustrates, in 2002, the baby boomers (i.e., with a median age of 50) saved 20% of their after-tax income. This was *double* the savings rate of today’s 60-year-olds when they were in their 50s (i.e., ten years ago). Moreover, as this figure illustrates, savings rates tend to increase with age.

**Figure 48. Savings Rate by Age Group**



Source: CES

Yankelovich data confirm this strong inclination to save. In 2003, 20% of boomers said that they were putting *more* money into their savings accounts than they were in 1999, while 40% said they were saving the same amount. Only 17% felt that “I am saving enough money to cover all of my future needs.”

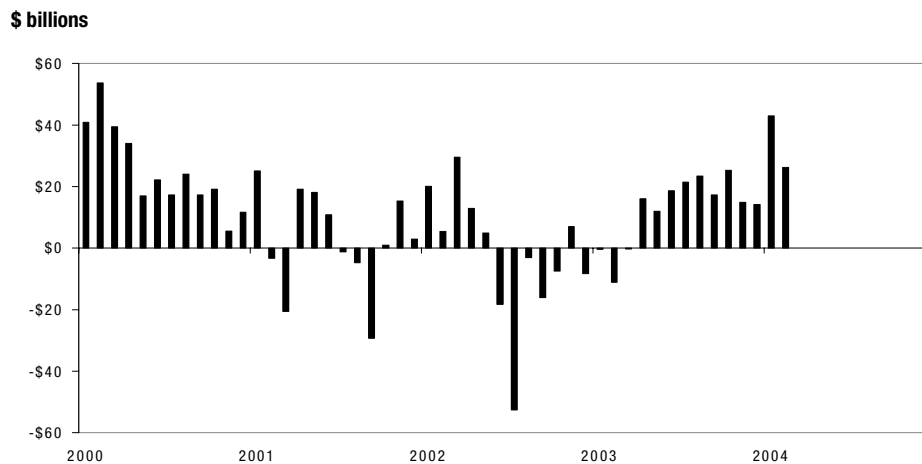
Even if boomers do not continue to save one-fifth of their after-tax income, their savings rate is still likely to be relatively high, given continued growth in real incomes driven by a rising participation rate and strong productivity gains. So where will that money go?

Lately, banks have been the recipients of huge amounts of cash. In the 1990s, bank deposits grew at a 6% annual rate, but since the equity market downturn began in 2000, bank deposits have grown at a 10% rate. A key reason for this has been the narrowing of the spread between money market yields and the interest rate paid on bank deposits. As this spread narrowed, many investors — also jolted by volatility in the equity markets — moved some of their financial assets to the relative stability of an FDIC-insured bank account.

**Seventy-three percent plan to move the money back to their investment accounts once the investment outlook improves.**

Reflecting the improved performance of equity markets of late, that flow has likely begun to reverse (see Figure 49). Indeed, Smith Barney banks and brokers & asset managers analyst Ruchi Madan’s September 2003 *Affluent Investor Survey* (order no. US08L100) revealed that, while 24% of affluent investors said they had reallocated funds from investments to their bank accounts, two-thirds (66%) said that they planned to move the money back to their investment accounts once the investment outlook improves. The 2004 survey (which will be available in May) indicates that percentage has risen to 73%. These results strongly suggest that the “equity culture” that developed among U.S. investors in the 1990s was not eradicated by the market downturn of 2000–02.

**Figure 49. Net New Cash Flow into Stock Mutual Funds, 2000–Present**



Source: StockVal

The Federal Reserve’s Survey of Consumer Finances quantifies the prevalence of this “equity culture,” particularly among baby boomers. Specifically, the percentage of *all* families that own equities, directly or indirectly, climbed to 21% in 2001 from 17% in 1992. Moreover, in 2001, 22% of families in the 45–54 age cohort owned equities. By comparison, in 1992 — when the boomers were about ten years younger — 19% of families in the 35–44 bracket owned equities.

**Investors most frequently blamed corporate executives and themselves for stock market losses.**

The resilience of the equity culture, as well as the anticipated flow back from bank deposits to investment accounts, is clearly bullish for selected U.S. brokers. Importantly, despite the recent scandals on Wall Street and the resulting reforms, it seems likely that the traditional full-service brokerage model will survive for the foreseeable future. For a start, the aforementioned survey of affluent investors revealed that investors most frequently blamed corporate executives and themselves for stock market losses. Indeed, fully 87% of investors rated the strength of a

research department as very or somewhat important when selecting a brokerage firm. Cost is apparently not a factor either, with affluent investors actually paying their brokerage firms three to five times more than they realize and 77% of clients saying that they would accept up to 5% higher fees from their brokerage firm. The 2004 survey suggests that percentage has risen to 84%.

***The brokerage industry may need to transform itself to more of an advisory-based model.***

Not only does it seem likely that the traditional full-service brokerage model will survive, but there also appears to be significant organic growth potential, particularly in the advice marketplace. More than half of the high-net-worth investors surveyed in 2003 did not have a professional financial adviser — even though 75% had a brokerage account — suggesting that many investors who have full-service relationships do not perceive their financial adviser as a provider of advice. The implication is that the brokerage industry may need to transform itself to more of an advisory-based model.

Survey data confirm this desire by investors for more advice on financial planning. Sixty-seven percent of boomers say that “I like to plan my finances at least five to ten years ahead,” but only 26% “always know which types of investments are right for me.” Indeed, just 27% of boomers describe themselves as “somewhat experienced” investors.

Brokerage firms that seem well positioned include *Merrill Lynch*, whose financial advisers are among the most productive (in terms of annual revenues), and *Charles Schwab* (Not Rated), which routinely brings in more assets than any of its peers.

***Already more than 65% of Merrill’s customer assets are from millionaire households.***

Merrill Lynch has been sharpening its focus in order to build a franchise in the high-net-worth segment — already more than 65% of its customer assets are from millionaire households. In fact, Merrill’s retail business has the deepest penetration in the high-net-worth investor segment, with a larger market share of high-net-worth assets (defined as \$1 million or more investable assets) than any other full-service brokerage firm.

In order to provide more products, services, and advice to its more sophisticated client base, Merrill is pursuing the following initiatives with its financial advisers:

- ▶ *Incentives.* Advisers are driven by a compensation plan that rewards servicing high-net-worth clients and penalizes behavior that does not maximize profitability.
- ▶ *Deepening Relationships.* Merrill is pursuing a cross-sell strategy by offering many new products and services, such as deposits, insurance, trust services, credit cards, and mortgages.
- ▶ *Training/Certifications.* Merrill is requiring every new trainee to graduate from its training program by earning the Certified Financial Planner (CFP) designation. Furthermore, Merrill is also aggressively hiring newly minted MBAs, which is uncharacteristic for the retail brokerage industry but commonplace for wealth management firms.

Another firm that appears well positioned is Charles Schwab, which has been successfully targeting the “younger affluent,” including the youngest boomers currently in their 40s. Historically, Schwab derived much of its growth from the more self-directed customers of the large full-service brokerage firms who wanted to trade with “play money” at lower commission rates. However, as the company has pushed to compete for higher-net-worth customers, it has been expanding into a more full-service offering.

As a result, Schwab today has four main sources of earnings:

- 1 Retail brokerage, which generates about 55%–60% of earnings.
- 2 Support services to independent investment advisors, which account for 30%–35% of profits.
- 3 U.S. Trust (serving ultra high net worth clients), which generates about 10%–15% of earnings.
- 4 OTC market-making, which accounts for less than 5% of profits.

Schwab’s strategy appears to be working, with the firm routinely bringing in more assets than any of its peers. And while Schwab’s account growth has been negative recently, this reflects the fact that the company has been purging unprofitable customers — 80% of accounts that were closed in 2003 had less than \$50,000 in assets.

**Seventy-one percent say “when I invest my money, I always look for safe investments, even if it means getting a lower return on my money.”**

Among asset managers, *T. Rowe Price* (Not Rated) seems relatively well positioned. The firm is perceived as an advocate of the individual investor with its no-load, low-cost approach and solid investment performance. Survey data reveal that boomers are conservative investors, with 71% saying that “when I invest my money, I always look for safe investments, even if it means getting a lower return on my money.”

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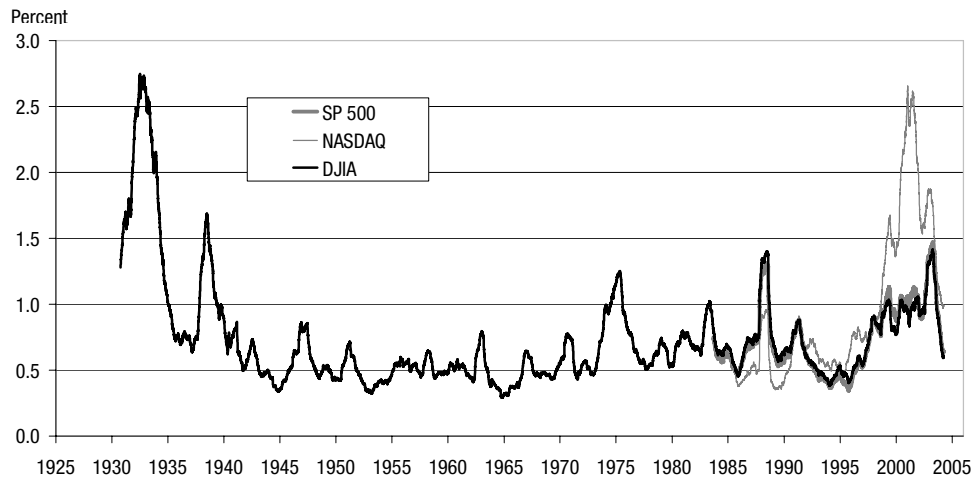
## **Looking for Safe Investments — A “Killer App”?**

As we noted previously, boomers are conservative investors, with seven in ten saying that they “always look for safe investments.” A key factor likely driving this conservatism is uncertainty about the future, as manifested by:

- *Yankelovich MONITOR* data reveal that 70% of boomers say that, during their retirement years, they “expect to have to be more careful about how to save and spend money.”
- For a married couple aged 55, there is a 45% probability of at least one of the two living to age 95, and a 24% probability that at least one of the two will live to age 100. So, with the longevity rate rising steadily, boomers face the rising risk of “living too long” rather than “dying too soon.”
- There has been significant volatility in financial markets in recent years, with the Nasdaq in 2000 being as volatile as the Dow Jones Industrial Average (DJIA) in 1929 (see Figure 50).

**Figure 50. Market Daily Price Volatility, 1925–Present**

Absolute value; 200-day moving average



Source: Reuters

In such an environment, investors are very concerned about safety of capital. The problem is that, given the current very low interest rate environment, a traditional annuity product generates paltry returns. For example, the purchase of a \$500,000 annuity today would produce just \$30,000 in annual income.

Fortuitously, *Hartford Financial* may have stumbled upon a “killer app” for the financial needs of today’s boomers: a Guaranteed Minimum Withdrawal Benefit (GMWB). At a cost of 50 basis points, this product offers the opportunity to invest in a range of financial assets including equities, and guarantees the return of the full amount of principal, provided that the initial principal amount is not withdrawn at a rate faster than 7% per year, which means that all the invested funds can be retrieved after 14 years of withdrawals.

***Hartford Financial may have stumbled upon a “killer app” for the financial needs of today’s boomers: a GMWB.***

GMWBs offer the following advantages:

- All the upside of equities;
- Safety of principal; and
- Full liquidity (that is, an investor can withdraw the *net* amount of funds at any time he or she chooses to withdraw).

Not surprisingly, demand for GMWBs has been explosive; Hartford’s variable annuity sales rose to \$15 billion in 2003 from \$10 billion in 2002. In addition to Hartford, only a handful of firms have both the capital and the ratings to be able to offer such a product. We believe the key issue in this regard is how the insurance company hedges the potential risks involved. And for the purchaser of a GMWB, it is not truly riskless, in that it is dependent upon the ongoing financial strength of the issuer.

In a stress-testing scenario, Hartford Financial estimated that a \$10 billion block of new business with GMWB benefits issued back in first quarter 1995, *if unhedged*, would have caused its GAAP earnings to swing to a loss of almost \$300 million

from a profit of almost \$300 million *just in the space of 12 months*. Hedging is also critical because, given the nature of the product, the more the equity markets go down, the greater the propensity to utilize the guarantee provided by the GMWB (and vice versa) is.

While demand for GMWBs has been strong, it is likely to get even stronger once this product is introduced into the 401(k) market. Bear in mind that the value of the average variable annuity purchase is \$50,000, while Smith Barney life insurance analyst Colin Devine estimates that the value of the average 401(k) rollover is at least ten times that amount.

Along with Hartford, other beneficiaries of the surge in demand for GMWBs include *Lincoln National* (which, after launching its GMWB at the end of second quarter 2003 experienced a large jump in sales) and *Prudential Financial*.

***The demand for traditional mortality protection life insurance products is not growing.***

Finally, note that while boomers' demand for products such as GMWBs is rising, the demand for traditional mortality protection life insurance products has been relatively stable. This reflects the fact that, as noted above, boomers are living longer, as well as the fact that their kids are largely grown up and are no longer financially dependent on their parents. (The one exception to this is the continued use of life insurance by affluent boomers for estate-planning purposes.)

# Active

**Boomers have always been work centered and should remain so.**

We noted previously that boomers are staying in the labor force longer and working past retirement age. However, three in five boomers (62%) consider it important to have “a successful balance between work and personal life.” So, on the one hand, boomers have always been work centered and should remain so. But on the other hand, it is not just about work. In fact, more than half of boomers (54%) value “being able to take a day off when you want to.”

The active lifestyle of boomers creates a range of opportunities for companies in a variety of industries. Working boomers want to live within a reasonable commuting distance to their place of employment. This is contributing to heavy spending by boomers on housing (including home improvement) and vehicles (particularly top-of-the-range models). And when they relax, time-starved boomers want to stay at upscale hotels that offer adult-oriented attractions, e.g., gambling.

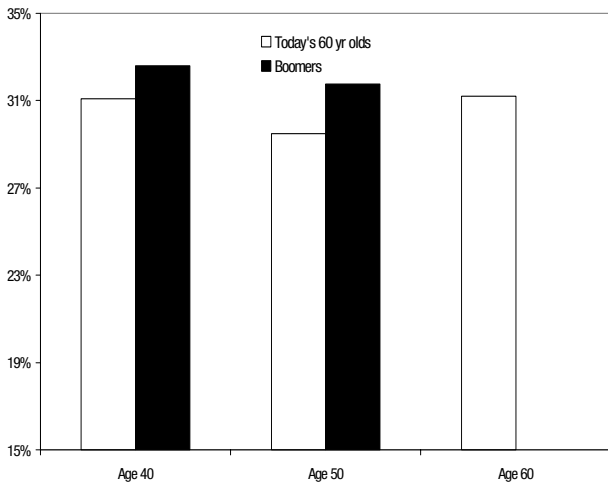
## The Active, Working Boomer

**Spending devoted to housing and transportation should increase as boomers move from their 50s into their 60s.**

As Figure 24 illustrates, the two categories that boomers spend the most on today are housing and transportation. Not only are boomers spending more on these categories than people in the cohort ahead did when they were in their 50s but, based on the historical pattern, the amount of spending devoted to housing and transportation should increase as boomers move from their 50s into their 60s (see Figure 51 and Figure 52).

**Figure 51. Spending on Housing**

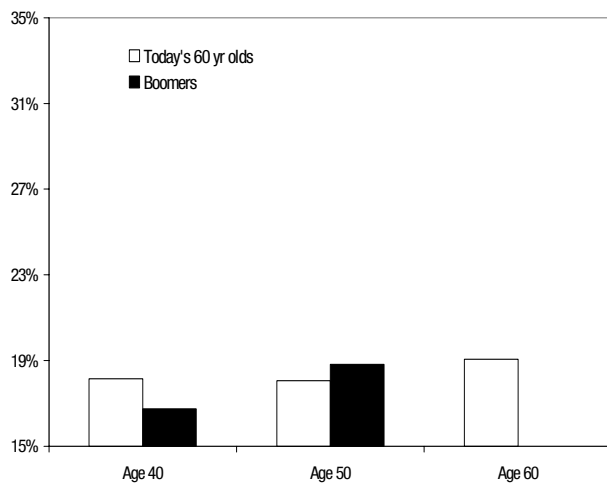
As a percentage of total expenditures



Source: CES

**Figure 52. Spending on Transportation**

As a percentage of total expenditures



Source: CES

## Housing

As we discuss below, many sectors of the housing market are enjoying robust demand driven, in large part, by heavy spending by boomers. Importantly, the supply outlook is also very positive, thanks to two key factors:

- 1 *Restricted Access to Capital.* Beginning in the mid-1990s, tighter lending standards began to limit access to capital for small builders, the 93% of builders who construct fewer than 25 homes per year. The reason for this was that, in 1995, concerns the housing sector had reached a cyclical peak became widespread. The “proof” of this was 1) no upcycle had ever lasted longer than four years, and 1995 would represent an unprecedented fifth year of expansion; 2) interest rates rose dramatically; and 3) levels of speculative inventory were growing. As a result, credit to finance small builders’ speculative building tightened sharply.
- 2 *Land Constraints.* While the credit situation has eased somewhat since 1995, land constraints have only intensified, and now represent a far more serious impediment to builders. Anti-sprawl sentiment has gained significant momentum in recent years and, concomitantly, the land approval process has lengthened considerably. The result has been a scarcity of buildable lots for sale.

These factors work in favor of big builders, who:

- Are financed by the capital markets.
- Develop much of their own land.
- Have a track record of navigating the onerous and complex land development process.
- By virtue of their strong balance sheets and superior portfolio of successful communities, receive “first looks” at lots that are made available by third party developers.
- Currently control a roughly four-year land supply.

On the demand side, affluent boomers have plenty of money to spend on homes.

***Boomers are attracted to “jewel boxes.”***

Increasingly, those boomers are attracted to what *Toll Brothers’* CEO, Robert Toll, has labeled “jewel boxes” — homes that, while modest in square footage, offer an impressive array of upscale amenities, including professional-grade kitchens, luxurious bathroom designs, as well as top-of-the line flooring and other furnishings.

***Building homes close to metro areas is a key strategy.***

In addition to buying “jewel boxes,” boomers are also attracted to housing communities oriented toward active adults. In that regard, following its 2001 purchase of Dell Webb, *Pulte Corp.* is a developer of small gated communities close to major metropolitan areas (see Figure 53). Building homes close to metro areas is a key strategy given that 1) active boomers plan on working well into their retirement years, and 2) studies have shown that 90% of retirees do not move once they do retire.

**Figure 53. Geographic Location of Pulte's Communities in the U.S. and Puerto Rico**

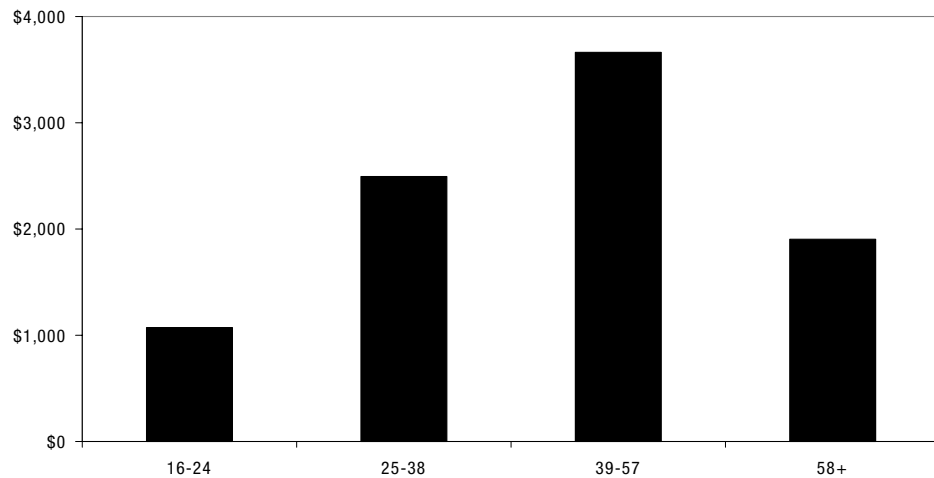


Source: Pulte Corp.

***Boomers spend significantly more on home improvement than any other age group.***

Many boomers will, however, choose to stay in their current houses and spend on home improvement. Sixty-nine percent of boomers say that “I’m almost always doing little things to change or improve the look of my home.” Moreover, the mean amount that baby boomers planned to spend on home improvement in 2003 was \$3,663, significantly more than any other age group (see Figure 54).

**Figure 54. Mean Amount of Planned Spending on Home Improvement by Age Group in 2003**



Source: Yankelovich Partners, Inc.

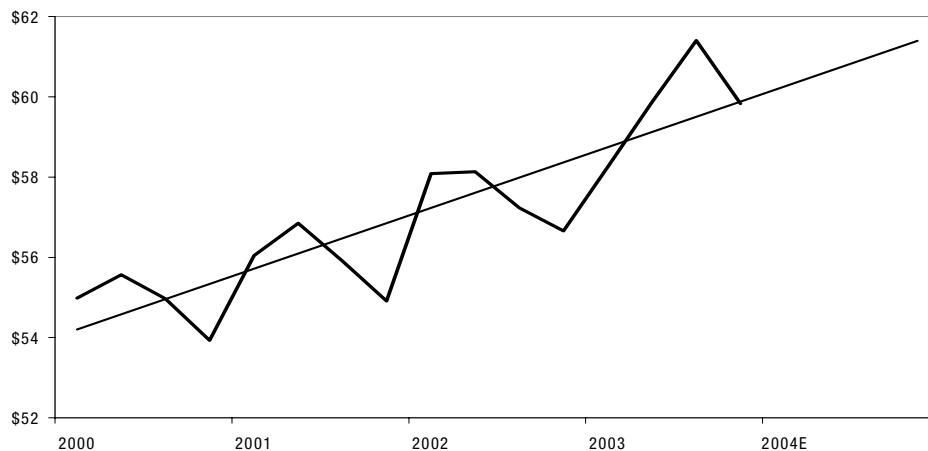
The relatively large sums that boomers are spending on home improvement likely reflects three factors:

- 1 *Refinancing.* Very low interest rates have enabled owners to extract equity from their homes, and then reinvest it back into the property in the form of repairs and upgrades.
- 2 *Limited Supply.* As discussed previously, the supply of land is constrained, which limits the property choices that are available.
- 3 *High Prices.* Reflecting the combination of limited supply and very low interest rates, home prices are high, which is restricting the ability of many boomers to trade up from their current residence.

Heavy spending on home improvement looks bullish for *Masco Corporation*, which offers an array of home furnishing brands, including Delta, HansGrohe Kraftmaid, Ginger, Behr paint, and Milgard windows. Each of these brands has a strong presence in the home improvement market.

Heavy spending on home improvement is also bullish for *Lowe’s* and *Home Depot*. For example, through its “Up the Continuum” strategy, Lowe’s has been successfully inducing upscale consumers to spend more on higher quality, higher price point goods. The result has been a steady improvement in Lowe’s average ticket size (see Figure 55).

**Figure 55. Average Ticket Size at Lowe’s, 2000–04E**



Source: Lowe’s Companies

Similarly, through its EXPO concept store, Home Depot is targeting the upscale population with income levels above \$100,000 and net worth above \$335,000 through a higher-end, higher price point product offering.

**An area that has great potential is DIFM.**

Finally, an area that has great potential, if it can ever be organized effectively, is do-it-for-me (DIFM). DIFM (or in-home service business) is a \$200 billion industry in which Lowe’s and Home Depot combined have less than a 5% market share. The opportunity seems large based on survey results:

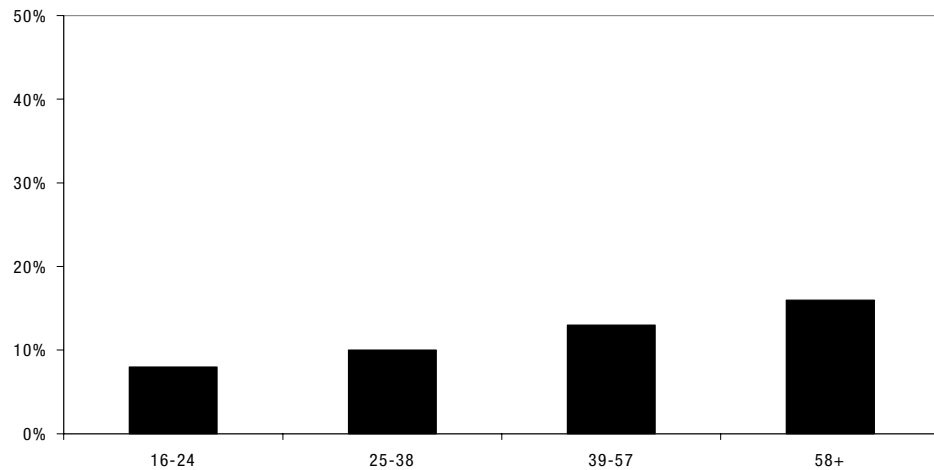
*Today's boomers dislike DIY projects.*

- The percentage of Americans that say they “hire someone to do a chore or task that I really hate doing” increases by age group (see Figure 56).
- Similarly, the percentage performing “do-it-yourself” (DIY) projects declines with the onset of middle age (see Figure 57).
- Moreover, today’s boomers dislike DIY projects much more than the cohort ahead of them — the percentage of people aged 45–54 who used DIY projects as a way to express themselves fell to 45% in 2003 from 61% in 1994.

While several companies have tried to offer DIFM (Sears with aluminum siding, RadioShack with satellite TVs), none have been successful. But given strong demand for DIFM by aging boomers, it seems likely that some company will eventually exploit this opportunity. Both Lowe’s and Home Depot recognize the market opportunity and are currently investing in technology to improve customer experience with in-home installation services.

**Figure 56. “To Treat Myself, I Hire Someone to Do a Chore or Task That I Really Hate Doing”**

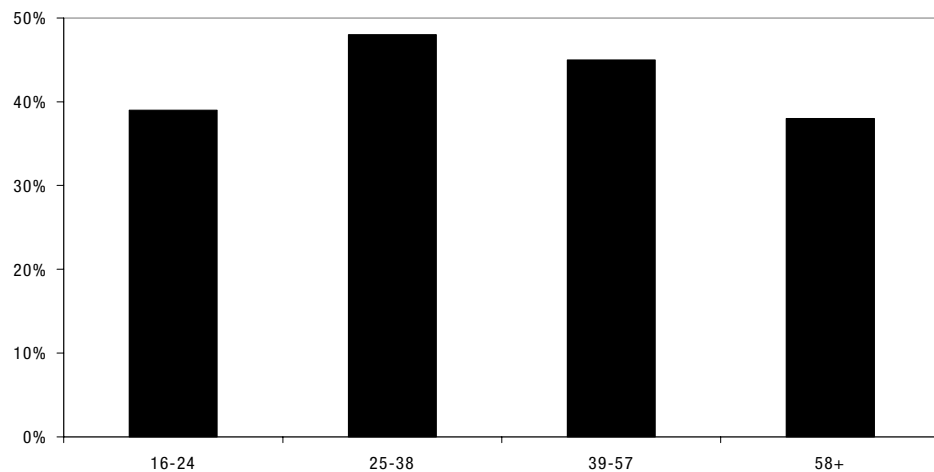
Percentage agreeing by age group



Source: Yankelovich Partners, Inc.

**Figure 57. Ways in Which You Express Yourself: Do-It-Yourself Projects**

Percentage agreeing by age group



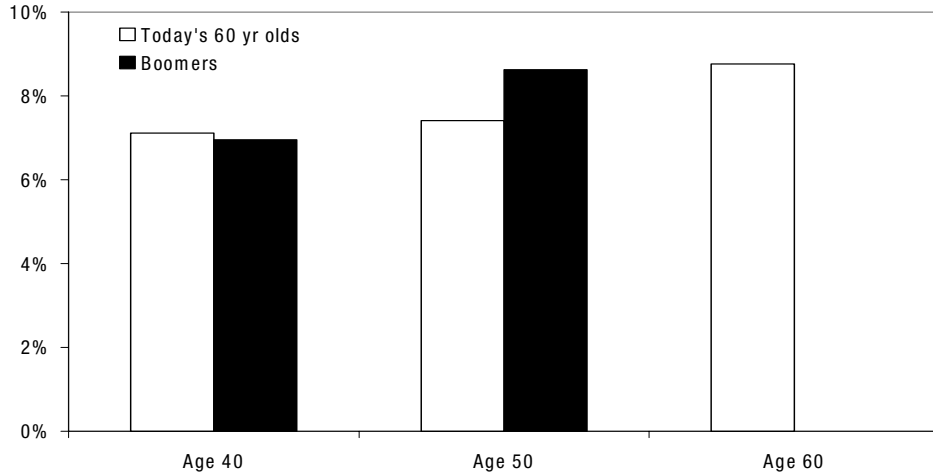
Source: Yankelovich Partners, Inc.

**Autos**

***Boomers are spending more on automobiles.***

Within the transportation category, spending on vehicle purchases is, not surprisingly, the largest category. In that regard, boomers are spending more on automobiles than people in the cohort ahead did when they were in their 50s, with that spending likely to increase further as boomers move from their 50s into their 60s (see Figure 58).

**Figure 58. Spending on Vehicle Purchases as a Percentage of Total Expenditures by Age**

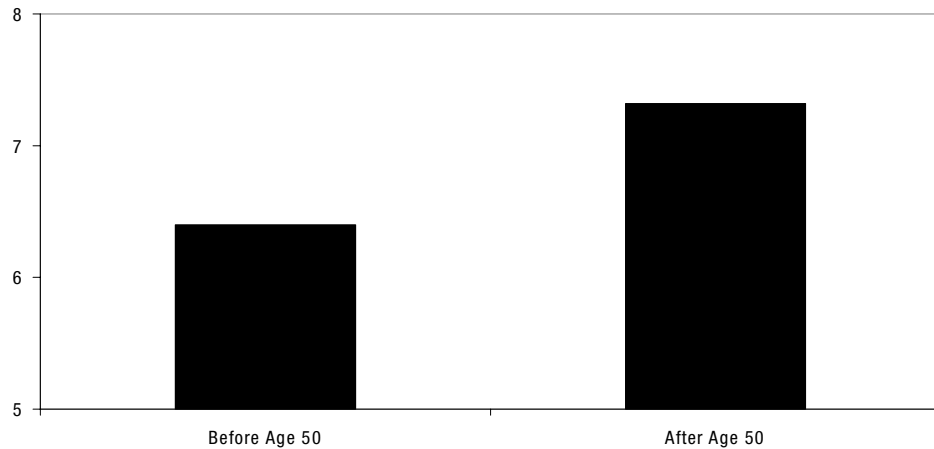


Source: CES

***Boomers turn over their cars relatively quickly.***

Heavy spending by boomers on vehicle purchases is particularly bullish for companies that supply the auto interior market because boomers have the disposable income to splurge on top-of-the-line vehicles crammed with “up-contenting” features such as heated and air-conditioned seats, as well as navigation systems and DVD players. Boomers turn over their cars relatively quickly, buying more new cars after the age 50 than before (see Figure 59), likely reflecting the fact that many boomers seem to want to drive a vehicle with the latest safety and entertainment features.

**Figure 59. Number of New Cars Purchased by Average American Household, Before and After Age 50**



Source: CNW Marketing Research Inc.

Auto supply companies that seem well positioned to benefit from these trends include Johnson Controls, Lear, and *Magna International* (all Not Rated). These suppliers design, manufacture, and assemble integrated vehicle interior solutions focused on seating systems, cockpits, doors, overhead systems, and flooring. Each enjoys a roughly 30% share of the U.S. automobile interior market. Interior suppliers are experiencing particularly rapid growth as automakers quicken the pace of outsourcing interior design and assembly to Tier I suppliers.

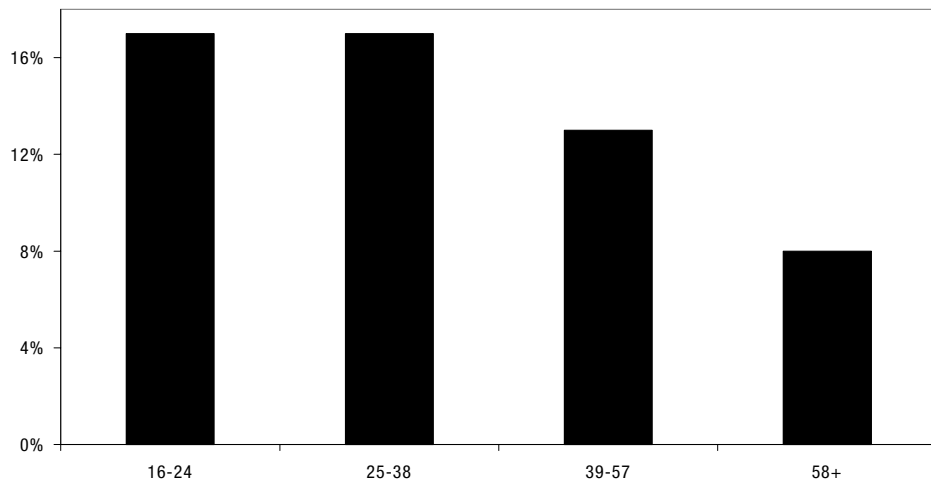
While the aforementioned suppliers typically assemble and integrate the latest “bells and whistles” into the interior systems, the up-contenting features are typically designed and manufactured by other suppliers. Long known for its high-end consumer audio products sold through the retail channel, *Harman International* (Not Rated) is now the technology leader in vehicle “infotainment” systems. The company’s integrated infotainment systems bring together audio, video, climate control, telematics, and other multimedia functions into one system with one display, thus eliminating various redundant components such as controls, wiring harnesses, boxes, displays, circuits, and power supplies.

***The percentage of people who list “working on the car” as a leisure activity falls with age.***

Finally, note that heavy spending by boomers on vehicle purchases does not seem to be a positive for auto supply retailers. The key demographic for auto parts suppliers is low- to middle-income Americans who cannot afford to take their car to a mechanic, and who try to repair it themselves. With boomers in their peak earning years, it is not surprising that the percentage of people who list “working on the car” as a leisure activity falls with age (see Figure 60).

**Figure 60. Activities Most Likely to Do for Fun and Enjoyment: Work on the Car**

Percentage agreeing by age group



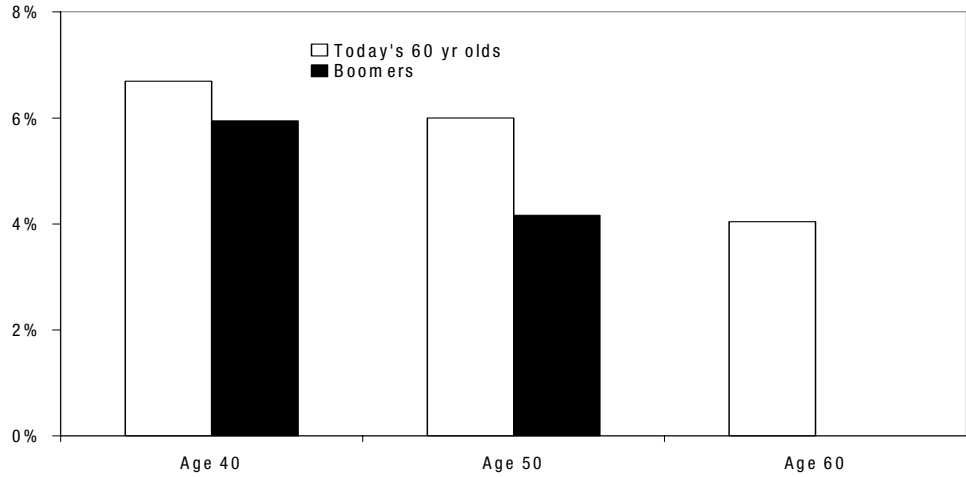
Source: Yankelovich Partners, Inc.

**Retailing**

*The outlook for apparel is not very favorable.*

In contrast to housing and autos, the outlook for apparel is not very favorable. Not only does spending on apparel typically decline as people age, but the amount that boomers are spending on apparel today is much less than what the cohort ahead of them spent when they were in their 50s (see Figure 61).

**Figure 61. Spending on Apparel as a Percentage of Total Expenditures**

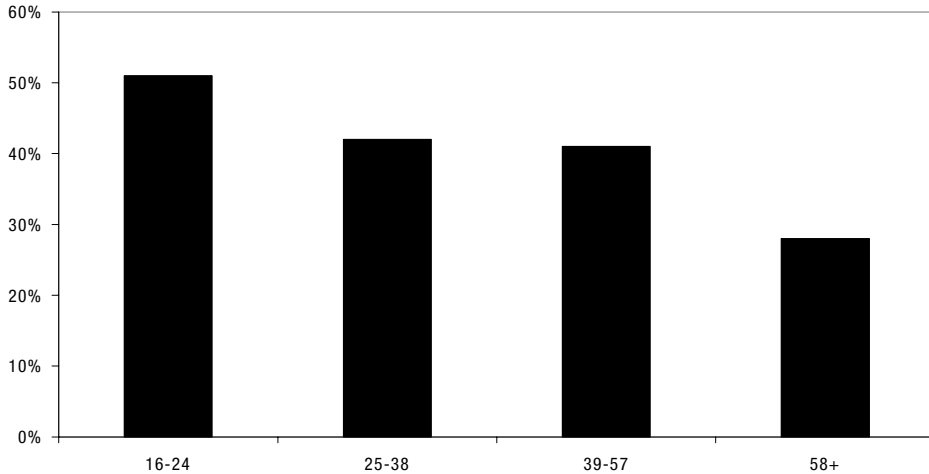


Source: CES

In addition, survey data reveal that:

- “Treating” oneself to new clothing declines steadily with age (see Figure 62).

**Figure 62. Ways to Treat Yourself: Buy Yourself Some New Clothing (Percentage Agreeing by Age)**

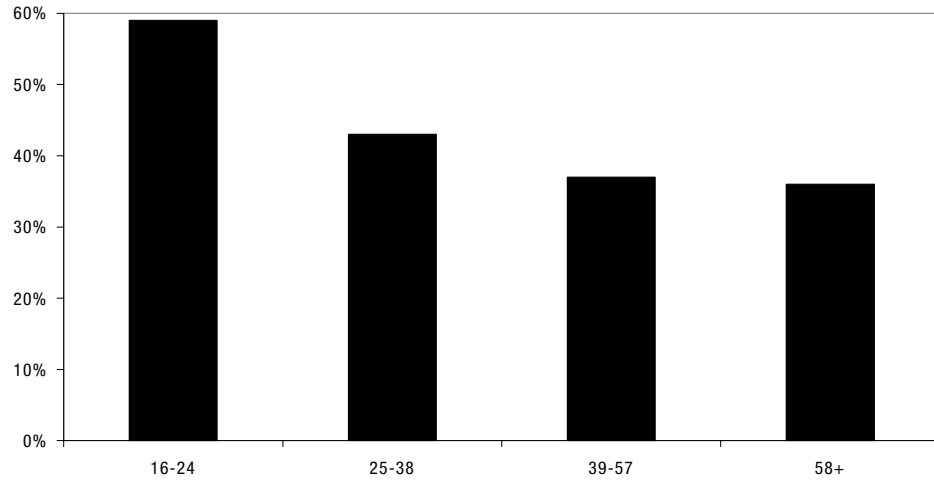


Source: Yankelovich Partners, Inc.

- Using clothes to express personal style also declines with age (Figure 63).

**Figure 63. Ways in Which You Express Yourself: Wearing Clothes That Express Your Personal Style**

Percentage agreeing by age

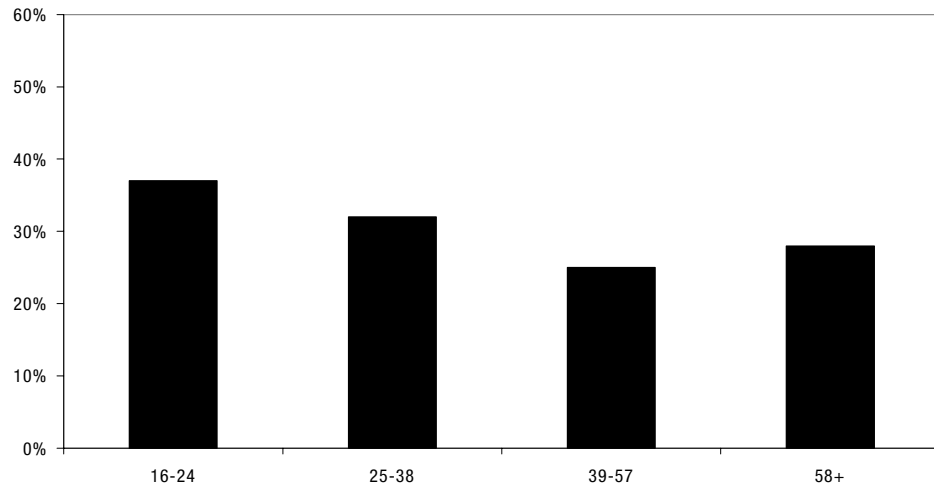


Source: Yankelovich Partners, Inc.

- Going shopping/going to a mall as a leisure activity declines steadily with age, but then picks up slightly as Americans move from boomers to the next cohort, “matures” (see Figure 64).

**Figure 64. Leisure Activity Likely to Do for Fun: Go Shopping/Go to a Mall**

Percentage agreeing by age group



Source: Yankelovich Partners, Inc.

A key reason why boomers today are spending less on apparel is that, with most of their material needs satisfied, boomers today *place more value on experiences than on tangibles*. As Figure 22 illustrates, when boomers were asked what they viewed as signs of success and accomplishment, “designer clothes” and “expensive jewelry” were among the three bottom-ranked categories.

***In this environment, retailers who cater to the desire for a “lifestyle experience” seem well positioned.***

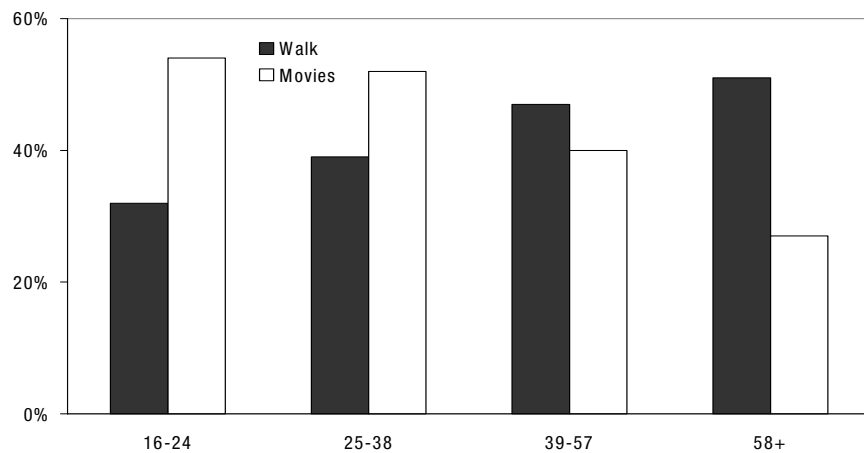
In this environment, retailers who cater to the desire for a “lifestyle experience” seem well positioned. *Neiman Marcus* offers its loyal and affluent customers a differentiated offering of premier luxury brands in a “one-stop shop,” as well as an unparalleled level of customer service. *Coach* (Not Rated) and *Williams-Sonoma* (Not Rated) are other upscale retailers whose strong brand franchises have a lifestyle connotation. By contrast, a company such as May Department Stores seems poorly positioned given its “barbell” focus on the younger (i.e., young women and teens) and older customer segments (in its Lord & Taylor chain).

### **The Actively Relaxing Boomer**

While it may be oxymoronic, boomers are actively relaxing, preferring leisure activities that are outdoors and engaging rather than indoors and passive. But, as we discuss below, boomers are lazily active, and not exerting themselves too much:

- They are taking a walk, rather than watching a movie (see Figure 65).

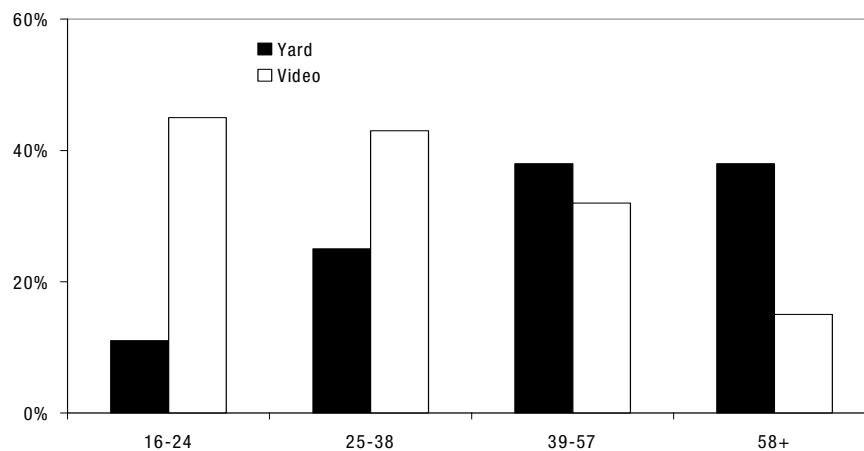
**Figure 65. Leisure Activity Likely to Do for Fun: “Take a Walk” vs. “Go to the Movies”**



Source: Yankelovich Partners, Inc.

- They are working in the yard, rather than renting a video (Figure 66).

**Figure 66. Leisure Activity Likely to Do for Fun: “Work in the Yard” vs. “Rent a Video”**

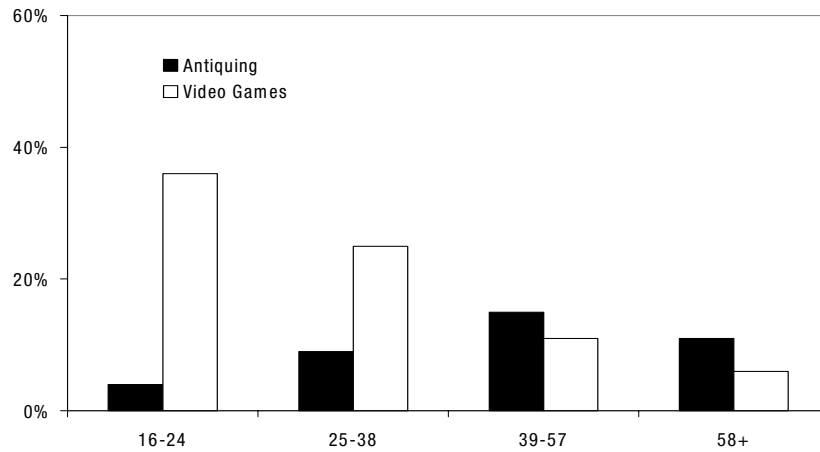


Source: Yankelovich Partners, Inc.

- They are going antiquing, rather than playing video/computer games (see Figure 67).

**Figure 67. Leisure Activity Likely to Do for Fun: “Go Antiquing” vs. “Play Video Games”**

Percentage agreeing by age group



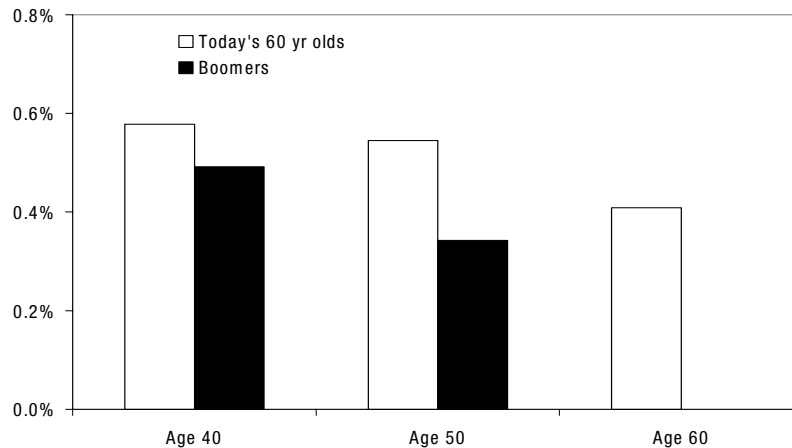
Source: Yankelovich Partners, Inc.

**Boomers are lazily active.**

So “actively relaxing” boomers are, in fact, lazily active. They enjoy walking as a leisure activity, but not running — only 15% like to run when they exercise. They enjoy cruising (42% of boomers have taken a cruise in the past five years), but not swimming — only 11% like to swim when they exercise. And they like driving (38% of boomers like to go for a drive in their spare time), but not hiking — only 11% go hiking.

Finally, note that, spending on reading material declines with age, with boomers spending much less reading than the cohort ahead of them (see Figure 68).

**Figure 68. Spending on Reading as a Percentage of Total Expenditures by Age**



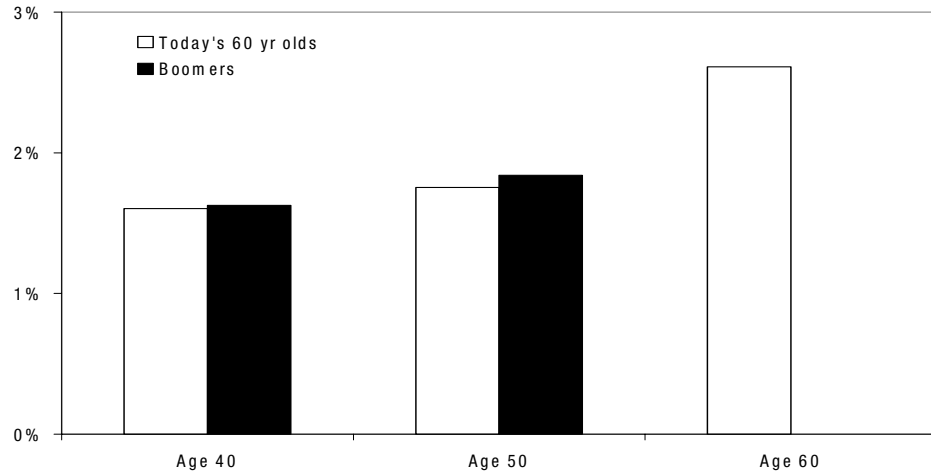
Source: CES

**Leisure and Travel**

**Boomers value “traveling for pleasure frequently.”**

Vacations are important to baby boomers. According to Yankelovich, boomers value “traveling for pleasure frequently” quite highly (see Figure 22). Not surprisingly, the CES data show a strong upward trend in spending on vacation-related activities, including lodging on out-of-town trips, auto rental, and air fare (see Figure 69).

**Figure 69. Spending on Leisure as a Percentage of Total Expenditures by Age**



Source: CES

**Demand for high-end leisure and travel products has been surprisingly strong in recent years.**

Demand for high-end leisure and travel products has been surprisingly strong in recent years, likely reflecting, in part, the large amounts of disposable income that boomers have. In the hotel sector, the beneficiaries of this trend have been, and will likely continue to be, non-commodity hotels offering a “lifestyle” experience. In this regard, hotels such as *Fairmont* (in Canada), *Four Seasons*, and *Starwood* (with its W and Westin chains) appear well positioned to offer time-starved boomers a high-quality, differentiated leisure experience. By contrast, Marriott and Hilton continue to primarily offer more traditional commodity-like products oriented toward business travelers.

**Las Vegas has, in recent years, gone back to being an adult-oriented “city of sin.”**

Starwood is also trying to increase its exposure to the attractive Las Vegas market. In recent years, Las Vegas has gone from being a family destination back to being an adult-oriented “city of sin,” which likely appeals to many child-free boomers. It is also likely that, at the same time that boomers are frequenting an adult-oriented “city of sin” such as Las Vegas, they are spending less time in ride-oriented theme parks, such as those operated by Six Flags. Seventy-four percent of boomers *totally disagree* with the statement “I like to engage in activities that most people think are dangerous,” compared to *total agreement* with this statement by 46% of those aged 16–24.

Of course, a key attraction in Las Vegas is gambling. Spending on gambling has increased sharply in recent years, reflecting

- Increased ease of access,
- Technological advancements, and
- The implicit approval of state governments (which are desperate for revenues in the face of exploding budget deficits).

***Gambling is fast becoming the “new lipstick,” i.e., a cheap way of escaping anxiety.***

Indeed, this increase is something of a self-perpetuating cycle for casino operators and gaming equipment manufacturers. Studies have shown that, once a person gets involved with the most simple form of gambling (e.g., a slot machine), he or she rapidly progresses to more sophisticated — and profitable — games (e.g., card tables). One could argue that gambling is fast becoming the “new lipstick,” i.e., a cheap way of treating oneself and escaping the lingering anxiety that weighs on the minds of today’s older baby boomers.

In addition to casino operators such as *Mandalay Resort Group*, gaming equipment manufacturers, including *International Game Technology* and *GTECH Holdings*, appear well positioned to benefit from continued growth in gambling. The proliferation of places where gambling is permitted is increasing demand for machines, while technological advances (such as the “reverse engineering” of a bingo game into a slot machine) are facilitating continuous product innovation. These factors, as well as ongoing state budget deficits, should fuel growth for years to come.

### **Cruising for Activity**

***Demand for cruise ship vacations has also been surprisingly resilient.***

***Cruising satisfies the key desire of boomers for an experience that is stimulating and adventurous — yet safe.***

As is the case with high-end hotels, demand for cruise ship vacations has also been surprisingly resilient. *Carnival Corp.* and *Royal Caribbean Cruises* are key beneficiaries of this trend, as the two companies are effectively a duopoly in the cruising industry, controlling 85% of market share. Importantly, cruising satisfies the key desire of boomers for an experience that is stimulating and adventurous (yet safe), with plenty of choices to personalize the experience. Royal Caribbean’s “get out there” advertising campaign emphasizes active (although not necessarily athletic) options on its cruises e.g., Alaskan treks and ice skating. Thanks to this and other campaigns, the industry has shattered the image that cruise ships are just for the “newly wed, nearly dead, and overfed,” and cater instead to the core active boomer market.

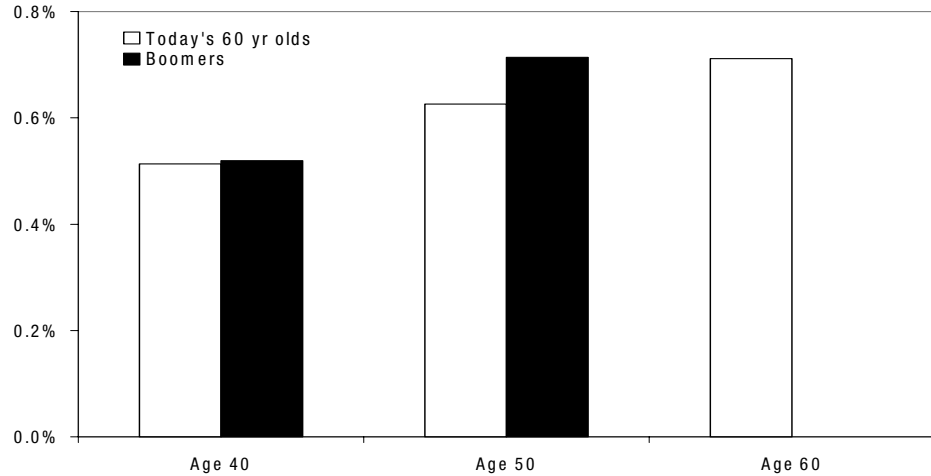
### **Playful Pets and Antique Prints**

In terms of leisure activities done at home, active boomers are interested in pets and antiques, but not in playing video games, going online, or buying books.

***Boomers say they receive “a great deal” of satisfaction from their pets.***

While the typical customers of pet retailers have, historically, been families with children aged 8–14, “empty nester” baby boomers have lately been important drivers of growth in this category (see Figure 70). In fact, more than one in four boomers (28%) say they receive “a great deal” of satisfaction from their pets. And reflecting their high levels of disposable income, these boomers have been spending heavily on high-end pet food and supplies, as well as on grooming services. Both *PETCO Animal Supplies* and *Petsmart* (Not Rated) are beneficiaries of this trend.

**Figure 70. Spending on Pets as a Percentage of Total Expenditures by Age**



Source: CES

As we saw, boomers are also interested in antiques (see Figure 67), but only as long as it satisfies their desire for a unique experience. As the May 1, 2003 issue of *American Demographics* points out, “while the World War II generation transformed their frugal roots into a fondness for collectibles — plates, Precious Moments dolls, Hummel figurines — boomers have shown little interest in such decorative items.”

***Targeting the market for antiques (or clever reproductions thereof) is an opportunity that will eventually be exploited.***

In terms of the type of antiques that appeal do boomers, *American Demographics* has observed that “the antiques (or clever reproductions thereof) business, firms that make customized cars or anything with a ‘one-of-a-kind’ appearance...should have no trouble finding work. Makers of generic or low-quality, mass-produced goods may be in for a tough decade.” And while there are no companies currently targeting this market for “antiques (or clever reproductions thereof),” it seems that, like DIFM, this is an opportunity that will eventually be exploited.

Companies mentioned in this report: Amgen Inc. (AMGN-\$60.43; 1M), Anthem, Inc. (ATH-\$88.39; 1M), Avon Products (AVP-\$79.05; 3M), BJ's Wholesale Club (BJ-\$25.20; 1H), Carnival Corp. (CCL-\$44.57; 1M), Constellation Brands (STZ-\$32.75; 1H), Darden Restaurants (DRI-\$23.79; 2M), Estee Lauder Companies Inc. (EL-\$44.00; 2M), Fairmont Hotels & Resorts (FHR-\$26.20; 1M), Four Seasons Hotels Inc. (FS-\$53.23; 3H), GTECH Holdings Corp. (GTK-\$63.25; 1M), Genentech, Inc. (DNA-\$112.00; 1H), Hartford Financial Services Group, Inc. (HIG-\$64.52; 2H), Home Depot, Inc. (HD-\$36.00; 1L), International Game Technology (IGT-\$46.15; 1H), Lincoln National Corp. (LNC-\$46.80; 1M), Lowe's Companies, Inc. (LOW-\$52.86; 1M), Mandalay Resort Group (MBG-\$61.20; 2H), Masco Corp. (MAS-\$28.86; 2H), Merrill Lynch & Co. (MER-\$58.25; 1M), NBTY (NTY-\$34.78; 2H), PETCO Animal Supplies, Inc. (PETC-\$27.80; 1H), Procter & Gamble (PG-\$106.02; 1L), Prudential Financial, Inc. (PRU-\$44.04; 1M), Pulte Corp. (PHM-\$47.95; 1H), Royal Caribbean Cruises, Ltd. (RCL-\$45.29; 1H), Starwood Hotels and Resorts (HOT-\$41.32; 1M), The Neiman Marcus Group, Inc. (NMGA-\$51.18; 1H), Toll Brothers Inc. (TOL-\$40.72; 1H), UnitedHealth Group (UNH-\$65.06; 1M), Weight Watchers (WTW-\$41.83; 2H), WellPoint Health Networks (WLP-\$112.00; 1M).

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**Notes**

**ANALYST CERTIFICATION****Appendix A-1**

Edward Kerschner and Michael Geraghty hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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**Smith Barney Equity Research Ratings Distribution****Data current as of 31 March 2004**

	<b>Buy</b>	<b>Hold</b>	<b>Sell</b>
Smith Barney Global Equity Research Coverage (2326)	36%	45%	19%
% of companies in each rating category that are investment banking clients	48%	44%	34%

**Guide To Investment Ratings:**

Smith Barney's stock recommendations include a risk rating and an investment rating.

**Risk ratings**, which take into account both price volatility and fundamental criteria, are: Low [L], Medium [M], High [H], and Speculative [S].

**Investment ratings** are a function of Smith Barney's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings are: Buy [1] (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold [2] (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell [3] (negative total return).

For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy [1] (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold [2] (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell [3] (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in risk rating, or a change in target price. At other times, the expected total returns may fall outside of these ranges because of price movement and/or volatility. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

Between September 9, 2002, and September 12, 2003, Smith Barney's stock ratings were based upon expected performance over the following 12 to 18 months relative to the analyst's industry coverage universe at such time. An Outperform (1) rating indicated that we expected the stock to outperform the analyst's industry coverage universe over the coming 12-18 months. An In-line (2) rating indicated that we expected the stock to perform approximately in line with the analyst's coverage universe. An Underperform (3) rating indicated that we expected the stock to underperform the analyst's coverage universe. In emerging markets, the same ratings classifications were used, but the stocks were rated based upon expected performance relative to the primary market index in the region or country. Our complementary Risk rating system -- Low (L), Medium (M), High (H), and Speculative (S) -- took into account predictability of financial results and stock price volatility. Risk ratings for Asia Pacific were determined by a quantitative screen which classified stocks into the same four risk categories. In the major markets, our Industry rating system -- Overweight, Marketweight, and Underweight -- took into account each analyst's evaluation of their industry coverage as compared to the primary market index in their region over the following 12 to 18 months.

Prior to September 9, 2002, the Firm's stock rating system was based upon the expected total return over the next 12 to 18 months. The total return required for a given rating depended on the degree of risk in a stock (the higher the risk, the higher the required return). A Buy (1) rating indicated an expected total return ranging from +15% or greater for a Low-Risk stock to +30% or greater for a Speculative stock. An Outperform (2) rating indicated an expected total return ranging from +5% to +15% (Low-Risk) to +10% to +30% (Speculative). A Neutral (3) rating indicated an expected total return ranging from -5% to +5% (Low-Risk) to -10% to +10% (Speculative). An Underperform (4) rating indicated an expected total return ranging from -5% to -15% (Low-Risk) to -10% to -20% (Speculative). A Sell (5) rating indicated an expected total return ranging from -15% or worse (Low-Risk) to -20% or worse (Speculative). The Risk ratings were the same as in the current system.

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