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Investment Megatrends

THE SUMMARY IN BRIEF

Megatrends are large social, economic or political changes that are slow to form — however, once in place, their influence can last decades. Demographics are a type of megatrend, and even though these trends are somewhat easy to spot, few, if any, investors focus enough on demographic trends as they make their investment decisions. These unique demographic trends can create investment opportunities, if you understand the link between demographics and investments.

Fortunately, Dr. Bob Froehlich understands this link quite well. As vice chairman of Scudder Investments, a part of Deutsche Asset Management, Froehlich applies dedicated research to discovering what lies ahead for the global economy, and how investors can capitalize on trends as they develop. He is a regular on CNBC, Fox, CNN and Bloomberg and is chairman of the Investor Strategy Committee, the first of its kind on Wall Street.

This summary gives investors a method to ride a global investment tide that's been building for more than a decade. Froehlich has done the legwork for you, and he shares the insights you need to make the most of your international portfolio.

IN THIS SUMMARY, YOU WILL LEARN:

- The power of demographic trends and how to use them to your advantage.
- The three major measures of demographics.
- How baby boomers hold the ticket to market success for the next 10 to 15 years.
- Why more than a decade after the fall of the Berlin Wall, Europe's economy is still feeling the effects.
- Why Japan's aging population holds the secret to good health and potential gold for investors.
- The reason China's growing consumer culture will put money in your pocket.
- The 20 companies you should invest in to develop an investment megatrends portfolio.



By Dr. Bob Froehlich

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THE COMPLETE SUMMARY: INVESTMENT MEGATRENDS

By Dr. Bob Froehlich

The authors: Dr. Bob Froehlich is the vice chairman of Scudder Investments. Scudder Investments is part of Deutsche Asset Management, which is the global asset management unit of Deutsche Bank. He also serves as Chairman of the Investor Strategy Committee.

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Investment Megatrends

John Naisbitt, perhaps the greatest “futurist” of our time, first coined the term “megatrends” in the early 1980s. Megatrends are large social, economic or political changes that are slow to form, however, once in place, their influence can last decades.

Demographics are a type of megatrend. Even though these trends are somewhat easy to spot, few, if any, investors focus enough on any demographic trend as they make their investment decisions.

During my investment career, I have had the opportunity to travel the globe meeting with financial advisors and business and political leaders around the world. As a result of my extensive worldwide travels, I have witnessed firsthand the evolving demographic changes taking place around the globe. These unique demographic changes can create investment opportunities if you understand the link between demographics and investments.

There are hundreds of demographic trends developing around the world. I have identified the four global demographic shifts that can make you rich over the next decade. While the numbers behind these global demographic shifts are important, they are about more than mere numbers. They are the stories of people and societies, the faces of children I have met from all walks of life, they are elders from different cultures with different values and traditions who have given me advice that somehow all come together to create the global demographic landscape. If you know where to look, this landscape is full of investment opportunities. ●

Understanding The Power of Demographic Trends

It took us a long time to realize the power of demographic trends on Wall Street. We are in good company because throughout history, few — if any — civilizations have understood the potential power of such trends, even if they are compiled demographic statistics. The governments of ancient Egypt, Rome and China all collected demographic data; their scope, however, was very limited. They counted their population so they would know how many people they could put in their military and how many people they could tax. Although in these respects, demographic surveys have been around since ancient times, the real foundation for demographics was set in the 1960s. It was then that governments moved beyond simply counting the living for tax and military purposes and began tracking how many people died, as well as compiling birth and marriage data.

The Father of Demographics

In the early 1600s, priests in London were required by law to compile a list every week showing how many of their parishioners had died of the plague. These lists were called Bills of Mortality. The government used the lists to identify where outbreaks of the plague were occurring so they would know which areas to quarantine. The Bills of Mortality eventually expanded to list other causes of death as well. Later, data on births and weddings were added.

It was from the Bills of Mortality that the founder of demography arose. John Graunt was a simple London merchant who was fascinated by these lists. Even though he had no formal training, the more he analyzed the Bills



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service@summary.com

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Rebecca S. Clement, Publisher; Philip Shropshire, Senior Contributing Editor; Andrew Clancy, Senior Editor; Joanne Merenda, Art and Design

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of Mortality, the more questions he had. It became his life's work. In 1662, he wrote a book titled *Natural and Political Observations Made Upon the Bills of Mortality*. His book raised issues about family size, health and place of employment. It was this book that finally helped people recognize the potential in studying demographic trends. As interest began to grow, first in medical statistics tracking specific causes of death, statistical offices had to be created to gather and keep track of all this information. It wasn't until the 1800s that the concept of a national census finally caught on.

What Is Demographics?

What exactly did John Graunt discover? *What is demographics?* In its most basic form, demographics is the study of population change and the underlying structure of that population. Demographics is a basic and simple concept. A limited number of events can change populations, and each of these events can be counted and tracked. These events are commonly referred to as the *demographic equation*. The equation sets forth that a country's population size can only change because of three types of events: births, deaths and migration.

From a technical perspective, demographic trends aren't listed as births, deaths and migration. When statisticians track the individual births of an entire country, the nation's trend is known as fertility. Likewise, the results of tracking the individual deaths of an entire country is known as mortality. Thus, *fertility, mortality* and *migration* make up the true demographic equation that drives all population changes.

Fertility. Fertility is simply the propensity of women in any given population to bear children. While to most casual observers, fertility (births) and mortality (deaths) both appear to be simple and straightforward, the analysis of fertility is much more complicated. First, people only die once and everyone dies, so mortality statistics are relatively easy to count. But fertility is much different. Women may have several children, or none at all. So with fertility, you are conducting an analysis of a repeated event. Second, death is typically determined by medical factors, and human factors only influence it to a limited degree. People do not usually choose to die, but their life may end due to an accident caused by someone else. That would be an example of a human factor, not a medical factor influencing mortality. But for the most part, medical factors, not human factors drive mortality. Just the opposite is true with fertility. Birth in most populations is subject to individual choice although governments may adopt laws that focus on and affect fertility. The simple way to think about it is that people get to

choose to have a child; they generally don't get to choose to die.

Mortality — Crude Death Rate. Mortality rates will vary greatly based on different characteristics. The most obvious is age. But mortality rates can also be influenced by a person's occupation and also by a person's sex. To understand mortality trends, we must do two things. First, we have to identify and measure mortality differences. Second, and even more important, we have to line up those differences to a particular characteristic. Think of it this way, if the mortality rates of two occupations differ greatly, that doesn't necessarily mean that the death was influenced by the occupation. Maybe this occupation requires more experienced people, and thus those people are older. So did the occupation contribute to their death or should we have focused on their age characteristic as the real factor?

The simplest and most widely used measure of mortality is the crude death rate. It is a simple calculation of the total number of deaths in a given period (usually one year) divided by the total population.

Migration. Migration is the third and final element of the demographic equation. Migration has evolved over time into the weak link of the three elements of the demographic equation. Statisticians spend more time, attention, analysis, research and understanding on fertility and mortality, whereas migration always comes in a far distant third. The reason is simple: Migration is the hardest and most complicated of the three elements to measure and analyze. Migration usually involves more than one country's population. When people move from the country where they were born to a different country, that move affects the population of both countries. Also, migration is not a one way street. People are traveling in both directions at the same time.

What Should You Look For?

With the foundation now being set for the demographic equation of fertility, mortality, and migration, it is time to interpret all this demographic data.

There are four basic rules to follow when looking at any demographic data:

One: Focus on the extremes: If any number is a real outlier, it deserves all your attention and you need to find out why it exists. Outliers occur for one or two reasons. Either there is a flaw or error in the data that caused the outlier or it was a unique circumstance that could give you real clues to future trends.

Two: Cluster the data. You will always be able to group or cluster some of the data. Then within that cluster,

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look for natural groupings. Are most people in this cluster from the same occupational category; or are they in a certain income level, be it high or low; or possibly do they all have poor health? Clustering allows you to begin to see beyond the numbers.

Three: Identify patterns. Fertility, mortality, and migration all vary by age, occupation, and ethnicity. These patterns will help develop the groundwork for future needs.

Four: Draw comparisons. This is the most important of the four rules. Draw comparisons, draw more comparisons, and when you are done, draw even more comparisons. The real underlying power of demographics is in drawing comparisons of the data with other places around the world. Then, you need to repeat the exact same procedure; only this time, compare your data to different time periods in the part of the world from which this information came. That way you can quickly see how this demographic trend has evolved and how that trend compares with the rest of the world.

Why Not Investments?

Did you ever wonder why demographic data is used in government and is used in business but is not typically used to drive investment decisions? We are missing the most important tool of all in investing — demographic trends. It is not the next economic release or earnings report that should drive our investment decisions, but rather demographics. Such trends have a longer term impact and they are easier to predict. Demographics need to become an important tool for investors. The following examples show how the baby boomer demographics in the United States have created investment opportunities.

Age Characteristics

When looking at statistics and data, whether on the Internet or on a paper copy, it is not enough to know what to look for in demographic trends and where to look for them. You also must grasp just why demographics are such a powerful investment tool. If you think of demographics and age characteristics as being one and the same, you will begin to see what I mean. Just think about the factors over which demographics and your age characteristics exert a major influence. First, your age characteristics are a key determinant of your consumption patterns. Not many 16-year-olds buy reading glasses. Likewise, not many 60-year-olds buy acne cream. And I've yet to see many 20-year-olds searching for just the right hair product to wash away the gray.

Second, your age characteristics greatly influence your level of savings and investing. Even though you may have great self-discipline and motivation to invest when you're younger, it is difficult because there are higher priorities such as raising your family or buying your first home. As you approach your first home, however, you suddenly seem to invest and save more. It is not because you are more motivated; it is because your age characteristics are now playing in your favor to help you save and invest. When you are 50, your children are grown and about to leave home and start life on their own. This frees up a great deal of cash. Also, that home that you have been paying a mortgage on for what seems like forever is just about paid off, which also frees up your cash flow. And, finally, at age 50, your employer pays you the financial rewards that you thought that you deserved at age 22. Your age characteristics just might be the most important factor you need to understand saving and investing.

Third, your age characteristics will determine both the size and makeup of your household. Very few teenagers think of starting a family, whereas that is on the top of the list for most young adults in their twenties.

Fourth and finally, the age characteristics of a nation have a strong influence on government policy. When a nation is driven by younger age characteristics, it spends money on schools and recreational programs. Conversely, a nation that is driven by older age characteristics tends to spend its money on retirement and medical benefits.

If you are an investor and you know what people are going to buy, when they are going to save and invest, how many houses are going to be needed, and how many people will live in those houses, as well as what the government policies are going to be, why would you need to know anything else? In the following sections I will explain the four most dramatic demographic shifts going on in the world today. After that, we will construct an Investment Megatrends portfolio based on these landmark demographic shifts, and together we will turn demographic trends into investment opportunities. ●

Global Shift 1: The Ponce De Leon Effect — The American Baby Boomers

Juan Ponce de Leon was a Spanish conquistador (Spanish term used to refer to soldiers, explorers, and adventurers). Ponce de Leon accompanied Christopher Columbus on his second voyage to the New World. He became the first governor of Puerto Rico. It was there that he first heard of the Fountain of Youth.

Over time, Ponce de Leon became dissatisfied with his material wealth, so he launched an expedition to find the Fountain of Youth. Instead, he discovered Florida, when on April 2, 1513, he reached land near what is now St. Augustine. He never found the Fountain of Youth but now almost 500 years later, the baby boomers have. The American Baby Boom Generation is more active and healthier than any previous generation in American history. But before studying these baby boomers, let's gain a broader perspective of the overall demographic picture.

The Senior Citizen-Focused Decades of the New Millennium

Now that these baby boomers are becoming card carrying senior citizens, they will be unlike any previous group of senior citizens. First, this group is not going to stand for gray hair and wrinkles. Instead of "working" in the traditional workplace, these senior citizens will focus on working at playing. And finally, they are going to be around a whole lot longer than previous demographic waves of senior citizens. Thus, unlike earlier senior citizen groups, not only will these baby boomer seniors focus on spending, they will focus on saving and investing as well. A confluence of three trends will distinguish this baby boomer generation as they become senior citizens: the travel and entertainment trend, the health and fitness trend, and the financial advice trend.

Boomer Spend

We need to take a look at what these baby boomers are buying compared to the country as a whole.

Baby boomers spend more than the rest of the nation on food away from home, which means they love to eat out. In addition, baby boomers spend more on transportation (planes, trains and cruises) than the rest of the nation; they also spend significantly more than the rest of the nation on their vehicle purchases, which means that they like expensive cars.

They also spend more on alcoholic beverages than the national average, outspending every age group in the country other than the category of adults 25 years and younger.

Demographic data can also be misleading. This doesn't necessarily mean that baby boomers drink more. My analysis suggests that they are simply paying more. Instead of cheap lite beer, they buy expensive premium imported beer. And if the whiskey is not at least 30-year-old scotch, don't even show it to them.

No matter how you cut it, these baby boomers are one of the great consumer generations. ●

Global Shift 2: The Walls Keep Tumbling Down — Eastern European Workers

It is not often that entire continents get the opportunity to recreate themselves: however, that is exactly what is happening today in Europe. When nations are in a transition, it becomes important to understand where they have come from, how they got there, and where they are going. To understand Europe, you not only must understand the sum of the parts, but must also be knowledgeable about the individual parts, or nations. What triggered this recreation of Europe? History will record that the Berlin Wall fell on November 9, 1989, but to get a more complete picture of the changes, we need to look back to August 23, 1989. On that day, Hungary removed its border restrictions with Austria, and within a month, over 10,000 East Germans fled Communist Germany through Hungary. In two months, East Germans began mass protests against the government that continued to keep them behind the Wall, blocked from pursuing opportunities in Western Europe. Unemployment ran high, while the East German government was forced to reduce state benefits, food was becoming scarce, and the quality of living was in a downward death spiral. Meanwhile, jobs were plentiful in West Germany, and the quality of living seemed to improve each month. The protests were so overwhelming that the leader of the East German government resigned on October 18, 1989.

What happened next was a series of blunders that led to the fall of the Wall. Less than a year after the Wall fell, East Germany and West Germany formally concluded their reunification on October 3, 1990. In many respects, this set the foundation for the European Economic and Monetary Union (EMU).

The European Union

The actual foundation for the EMU dates back to 1951 when a coalition was formed called the European Coal and Steel Community. It included Belgium, the Netherlands, Luxembourg, France, Italy, and West Germany. In 1973 Denmark, Ireland and the United Kingdom were added.

But it was after the fall of the Berlin Wall in 1989 and the reunification of Germany in 1990 that set the stage for diplomatic relationships between Western, Central and Eastern Europe. In 1992, the Treaty of Maastricht established the completion of the EMU as a formal objective and determined membership criteria on economic matters

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such as inflation, interest rates, and budget deficits. By that time, three more countries had joined the European Community: Greece, Spain and Portugal. These 12 countries became the original members of the EMU.

In 1995, Austria, Finland and Sweden joined the European Union, bringing the total number of member countries to 15. In 2004, the last walls left in Europe finally fell. On May 1, 2004, the EMU saw its membership roll swell with the admission of 10 more countries: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. The EMU now stood 25 countries strong, and for the first time in the modern era, Central and Eastern Europe could begin to act with one economic voice.

Double Impact of the European Union

The Iron Curtain is now gone and Eastern Europe and Western Europe have joined as one in the European Union. The first big impact of this union was the opening up of cheap labor in Eastern Europe. The easiest way to make money in business is to always find ways to do things better, faster and cheaper. The way to do things better, faster and cheaper in Europe is through Eastern Europe.

First Impact — Low Cost

When countries fall behind economically, there are ripple effects on health, welfare, and standards of living. These hardships do not turn around overnight, but with more income, things can get better. Think for a minute what the European Union means to the workers of Eastern Europe who, because of their poor standard of living, are the cheapest labor around. It is likely that more and more companies will begin to locate manufacturing operations in these countries to reap the financial benefit of low-cost workers. This, in turn, will help the overall economies of these Eastern European countries as well as help their own companies. National economic growth will beget corporate economic growth.

Second Impact — More Flexible Labor Standards

It is the shift of Eastern European workers to Western Europe that will cause the second impact: more flexible labor standards. It is no secret to anyone that extreme anti-business and anti-profit labor standards are major problems in industrialized Western Europe. Despite small concessions to management, the standards for work hours, vacations, layoffs and terminations are still greatly tilted toward the employee and against the employer, which ultimately means against profits as well. This, too, will change. As workers come from Eastern Europe to

Western Europe, they will be less demanding and more willing to accept a job working more hours with less vacation and less pay. The workspace landscape is about to change dramatically. This can create a win-win situation. The Eastern European economies get stronger while Western European companies get more profitable, which in turn will drive the Western European economies as well. This opening up of labor in Eastern Europe will finally bring about the structural reform needed in the labor laws, labor standards and labor traditions of Western Europe. ●

Global Shift 3: The Rising Sun Is Clearly Setting — The Aging Japanese Population

Throughout history, Japan has been referred to as the “Land of the Rising Sun.” Even the flag of Japan with its white background and large red disk in the center carries that message. The Japanese flag is called Hinomaru, which means “circle of the sun.” Where Japan and its rising sun are concerned, history is about to take a turn. Instead of referring to Japan as the land of the rising sun, we will now need to refer to it as the land of the setting sun, at least from a demographic perspective.

Japan is Aging

Japan is aging. By the year 2025, the proportion of the Japanese population aged 65 or older will be higher than any other age category. That will make Japan the oldest nation in the world. The most recent life expectancy figures are staggering: Japan has the highest life expectancy anywhere in the world. On the flip side, the average number of children Japanese women will bear has reached an all-time low of one child. Because of these two trends, Japan has the most rapidly aging population of any leading industrial country. The fallout from having the fastest aging population is a shrinking pool of workers to support the benefits received by senior citizens. Even in the best of market times, this demographic trend would be a problem. Because the Japanese equity markets in the past 15 years have experienced anything but the best of times, this trend is causing a real crisis in that nation.

Fiscal Impact

Now let's consider the potential fiscal impact that the aging population may have in Japan.

First, a little perspective: Japan's public finances worsened dramatically in the 1990s, which now makes dealing with its aging population even more challenging. Tax

revenues across the board spiraled lower when the housing and stock market bubbles both burst at the same time. To make matters worse, in an attempt to recover from those bursting bubbles, government expenditures rose to stimulate the economy, especially through infrastructure and big public works projects. Also, if a country's working age population is getting smaller, then a country's potential for economic growth must also get smaller. The only way around it is for productivity to rise faster than the labor force declines. ●

Global Shift 4: Napoleon was Right — The Chinese Consumer Generation

Some 200 years ago, Napoleon III likened China to a sleeping lion and warned that when China awakes “she will shake the world.” Now awakening from a long economic hibernation, China is certainly shaking the entire world, especially Chinese consumers. Within 10 years, these Chinese consumers will replace U.S. consumers as the largest and most important buying group anywhere in the world. All it takes is money. Today, only 4 million Chinese consumers earn more than \$10,000 annually. Maybe what Napoleon should have said is that when the Chinese consumer awakes, it will change the world!

China and Consumers

There are two parts to this global shift: China and consumers, together they are fueling this dramatic shift. In economic circles, a *consumer* is an individual or a group of individuals who consume goods and services in an economy. Consumers are thought to have a budgeted income that they can spend on any number of different goods or services available in an economy. It is assumed that consumers will behave rationally and will spend their budget only on goods and services that best fill their needs. In addition to buying goods and services, consumers also should invest part of their budget to increase future spending power.

The biggest change with consumers is the way the business world views them. No matter what you want to sell, to what age group, with whatever demographic features, chances are that you'll find more of them in China than anywhere else in the world. The 1.3 billion Chinese consumers represent the greatest consumption bubble in the history of time. ●

How To Develop An Investment Megatrends Portfolio

Now it's time to make some money. Let's connect the dots between these global demographic shifts — my Investment Megatrends — and the investment opportunities these shifts are creating. After briefly summarizing my investment perspective on each of the four global shifts presented here, I identify the five companies best positioned to benefit from each shift. You will then have a portfolio of the 20 global companies best positioned to make money from these four demographic shifts.

Consider these companies your Investment Megatrends Portfolio for the next decade.

Global Shift 1: The Ponce De Leon Effect — The American Baby Boomers

Several dominant themes emerge when focusing on American baby boomers. The first is that these baby boomers are going to continue to be big savers, and they are going to be looking for some financial advice. These baby boomers want to spend their retirement years looking at their grandchildren, not stock charts. The best way to invest in this theme is through brokerage and investment banking stocks because through the firm's investment banking arm, it can provide its brokers unique opportunities that other brokers can't access.

Merrill Lynch (Stock Symbol: MER): Merrill Lynch is one of the world's leading brokerage and financial management firms. The company offers the kind of one-stop shopping that the baby boomers will be looking for.

Dell (Stock Symbol: DELL): Dell Computers has one of the best and simplest business models anywhere. Dell is one of the most customer service friendly firms anywhere and Dell has over 60,000 employees worldwide waiting to customize a computer for picky baby boomers.

Carnival Corporation (Stock Symbol: CCL): Baby boomers want to see and experience it all in their lifetimes. They have the disposable income and wealth to travel anywhere they want. The best way to invest in the travel theme is through the world's number one cruise operator, Carnival Corporation, which also offers a wide array of pricing packages.

Molson Coors Brewing Company (Stock Symbol: TAP): One of the reasons that baby boomers spend so much on alcoholic beverages is that they pay more for imported beers. Coors also offers a lighter calorie beer for the weight conscious.

Johnson & Johnson (Stock Symbol: JNJ): Baby boomers are concerned about their health and fitness and the best way to do that is through Johnson & Johnson, one of the world's largest health care manufacturers.

Global Shift 2: The Walls Keep Tumbling Down —Eastern European Workers

Several dominant themes emerge when focusing on Eastern European workers and their likely impact on Europe. The first theme is that these low-cost Eastern European workers will provide a spark to economic growth, not just to Eastern Europe but to Western Europe as well, which will serve to further integrate trade and commerce among the 25-member European Union countries. The best way to invest in this increasing trade and commerce theme is in shipping.

Dryships Inc. (Stock Symbol: DRYS): Dryships are carriers of dry bulk goods. What uniquely positions them is that they serve the complete spectrum of sizes within the now vast EU. The range in demand will be very wide. They will have the ability to fill every order.

Mittal Steel Company N. V. (Stock Symbol: MT): Mittal Steel is the largest steel producer in the world, producing more than 50 million metric tons annually.

BASF (Stock Symbol: BF): If trade and commerce pick up in Europe, then the largest chemical company in the world should stand to benefit as well.

Ericsson (Stock Symbol: ERICY): If your standard of living increases, then you are more likely to buy a mobile phone and that means Ericsson wins.

Shire Pharmaceuticals Group (Stock Symbol: SHPGY): As the EU grows, Shire will benefit by being a drug company and also focusing on the specialty physician.

Global Shift 3: The Rising Sun is Clearly Setting — the Aging Japanese Population

Four dominant themes emerge when focusing on the aging Japanese population. The first is that not only does Japan have one of the oldest populations in the world but these senior citizens are the healthiest as well. Japan is ranked number one for healthy life expectancy.

Canon Inc. (Stock Symbol: CAJ): There simply is no way these healthy aging Japanese senior citizens are going to let all these memories go by without capturing them on camera or with a camcorder.

Fuji Photo Film Company (Stock Symbol: FUJIY): This company not only offers film and paper products, but entertainment products for a growing singles population.

Konami Corporation (Stock Symbol: KNM): No company is in a better position to fill entertainment needs than the Konami Corporation, which offers digital entertainment, video games and cell phones.

Sony Corporation (Stock Symbol: SNE): Sony offers a wide array of entertainment products for Japanese singles.

Mitsubishi UFJ Financial Group (Stock Symbol: MTU): This is one of the largest banks in the world and will benefit from money coming out of Postal Service Savings Accounts.

Global Shift 4: Napoleon was Right — The Chinese Consumer Generation

Five dominant themes emerge when focusing on the Chinese Consumer Generation. The first is that young Chinese consumers are buying things made in Japan, unlike their parents who still boycott such products because of the Japanese invasion and occupation of China in the 1930s. To these young Chinese consumers, that doesn't matter. They make their shopping decisions based on the quality of the product along with the price and that product's brand reputation.

Toyota Motor Corporation (Stock Symbol: TM): These young Chinese consumers are evolving from riding bikes to mopeds to autos. No company is better positioned to serve them than Toyota.

PetroChina Company (Stock Symbol: PTR): PetroChina produces over two thirds of China's oil and gas. It has its own domestic exploration business and already owns close to 10,000 miles of natural gas pipelines.

China Mobile (Stock Symbol: CHL): China has the largest group of mobile phone users anywhere in the world at 325 million. China Mobile will dominate because of its service.

Yum Brands, Inc. (Stock Symbol: YUM): In China, Yum operates Kentucky Fried Chicken, Pizza Hut, Taco Bell and Long John Silver's.

Avon Products, Inc. (Stock Symbol: AVP): The rising earning power of Chinese women means that Avon's products will grow in popularity. Avon is also already selling its products in China. ●