US equities

Golden years for Baby Boomers - update | 01 September 2017

Chief Investment Office Americas, Wealth Management
Laura Kane, CFA, CPA, Head of Investment Themes Americas, laura.kane@ubs.com

- The Baby Boom generation, by its sheer size, has always had an outsized influence on society. As its bulge has moved through different life stages, some industries have thrived while others have been displaced.
- Today, as Boomers enter into their hard-earned retirement and set out to enjoy their golden years, we expect various segments of the economy to benefit disproportionately.
- We see the most widespread support within the healthcare sector, where a combination of longer life expectancy and more intense reliance on pharmaceuticals, medical insurance and supplies should drive increased demand.
- Wealthy Boomers will have considerable time and purchasing power which should support segments of the consumer discretionary sector. In particular, travel and leisure companies such as cruise lines should experience tailwinds. Within consumer staples, Boomers will underpin growth in cosmetics companies and pharmacies.
- The wealth concentration within portions of the Baby Boom cohort, together with the need for different financial advice and products than prior to retirement, suggests that select asset managers and insurers will benefit.

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An influential generation

Following the Second World War, birth rates across the world spiked as families were formed during a prolonged period of peace and economic stability. This boom spanned from 1946 to 1964; and during this period total births per year in the US started at 2.3 million, jumped to 4.3 million, and ultimately settled back down at 3.1 million. With a current size of 77 million people, the Baby Boomers comprise about a quarter of the US population (Fig. 2) and control the largest share of household wealth.

Given the sheer size of this demographic cohort, we have observed the Boomers exert substantial influence over consumption patterns as they progressed through different life stages. Unlike their Depression-era parents, Boomers were able to spend on more than just necessities, and as a result, changed the nature of consumerism in the United States. During the 1950s, young Boomers fueled unprecedented demand for baby food and toys, and later in the decade, teenage Boomers helped to popularize fast food. Next, we saw dramatic shifts in preferences in fashion, music, and entertainment as the Boomers were caught up in the countercultural movement of the 1960s. The 80s brought the first personal computers and a surge in credit card usage as the Boomers entered their prime. By the 90s, Boomers were immersed in raising their own families and looking after their homes.

Baby Boomers are now moving into their next distinct chapter. In 2011, the first among them turned 65, and this will continue at a pace of approximately 10,000 per day for the next 15 years. By 2030, almost a quarter of the US population will be over the age of 65 (Fig. 3). This is significant as 65 is typically the age at which most people retire and become eligible for Medicare coverage. We think the aging and retirement of the Boomers will have significant implications for spending patterns, particularly in the healthcare, consumer, and financial sectors.

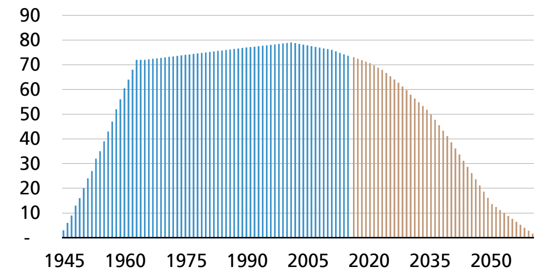
Measuring the Boomers' wealth

Based on the 2013 Survey of Consumer Finances (SCF), the Baby Boomers have the highest average household wealth of any other age cohort. But this wealth is not evenly distributed. We can observe this wealth disparity in the large discrepancy between the mean and median household net worth figures (Fig. 4). So while some Baby Boomers that are extremely wealthy, others are facing severe financial hardship. In our investment theme, we are targeting the more affluent Boomers by focusing on industries and companies that benefit from discretionary spending in entertainment, housing, and personal care categories, as well as financial services.

A substantial portion of Baby Boomers' wealth is contained in their tax-advantaged retirement accounts (IRA, Roth IRA, 401k, Keogh, etc.). The SCF shows that in some cases these accounts contain up to half of the net worth in a given age bracket. As the Baby Boomers retire these assets will be withdrawn from these accounts and utilized to provide funding for retirement. At age 59 ½ distributions from 401ks and Roth IRAs are allowed, and at age 70 ½ distributions from

Fig. 2: Population of Baby Boomers in the United States

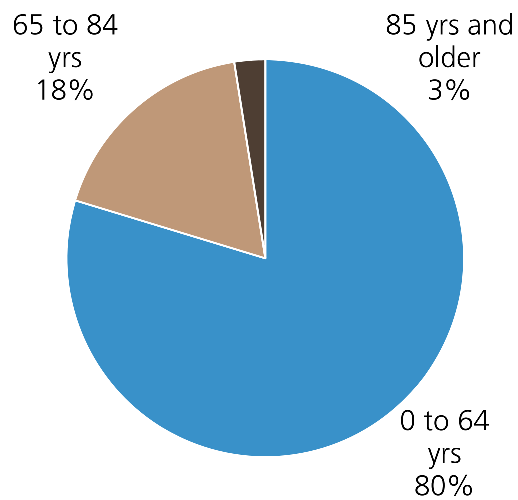
Number of individuals (in millions)



Source: U.S. Census Bureau, as of May 2014

Fig. 3: 2030 population age projection

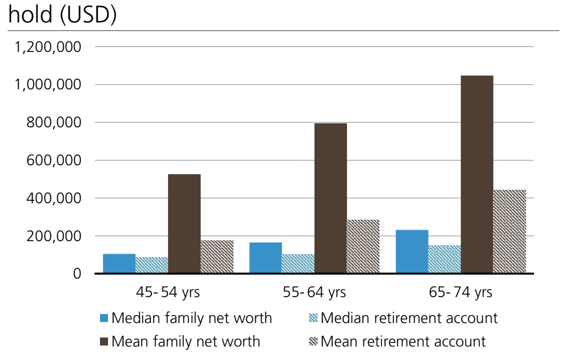
By percentage of total population



Source: US Census Bureau, as of May 2014

Fig. 4: Great wealth disparity among the Boomers

Mean and median net worth by age of head of household (USD)



Source: 2013 Survey of Consumer Finances, Federal Reserve

IRAs become mandatory. Data from the Employee Benefit Research Institute shows that in 2013 most withdrawals from IRAs were made by individuals aged 71-79.

Who benefits?

As the Boomers enter their next phase, we expect their discretionary dollars to be allocated differently. While housing and transportation make up the bulk of expenditures for this age cohort, this is pretty consistent across all age groups (Fig. 5). For our investment theme, we focus on the categories where we typically see a greater proportion of dollar spent as individuals enter their retirement years. Perhaps most significant will be the increase in their spending on healthcare as they manage the deleterious effects of old age. We also expect the wealthier Boomers to spend more on entertainment and leisure categories as they seek to enjoy their retirement years (Fig. 6). Financial services will be needed to help manage their wealth and ensure a smooth transition to life without a regular paycheck. Finally, we expect the nature of spending on housing to change as some Boomers consider selling their homes and moving to retirement and assisted-living communities – whether motivated by lifestyle preferences or health needs.

Healthcare

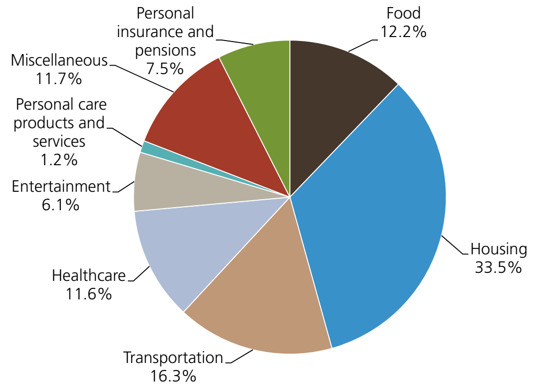
As the Boomers reach retirement age, they will likely need more medical care. Funding their healthcare needs will require them to cash in on their earned social benefits like Medicare as well as utilize their savings to buy private insurance. Unsurprisingly, the 2015 Survey of Consumer Expenditures (SCE) showed that older individuals spend a larger portion of their total expenditures on healthcare then younger generations. For example, healthcare spending accounted for approximately 8.7% of total expenditures for those ages 55-64 compared to 11.6% for those ages 65-74. We think the increase in dollars spent on healthcare will create opportunities for healthcare companies well-positioned to benefit from this uptick in demand.

Medical insurance

A major beneficiary of healthcare demand will be managed care organizations (MCOs, or health insurers). As Boomers turn 65, they are eligible for Medicare enrollment, which will drive an increase in the insured population. In addition to this demographic tailwind, MCOs are benefiting from moderate healthcare inflation. The notable exception to the otherwise favorable environment for MCOs arises from mandated state-run exchanges – from the Affordable Care Act – which have been a drag on profitability, but several MCOs have pulled out of the state-run exchange business, reducing losses and stabilizing earnings growth.

Fig. 5: Spending breakdown of persons in US aged 65-74

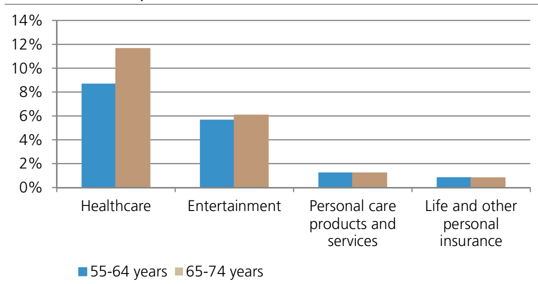
% of total expenditure



Source: 2015 Consumers Expenditure Survey, U.S. Bureau of Labor Statistics

Fig. 6: Spending patterns change after retirement

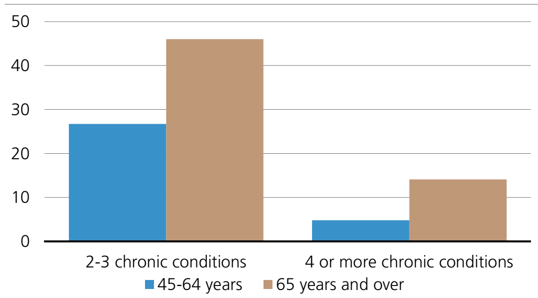
% of total expenditures, US



Source: 2015 Consumers Expenditure Survey, U.S. Bureau of Labor Statistics

Fig. 7: Prevalence of chronic disease rises after retirement

Percentage of age bracket with X number of chronic conditions, 2014



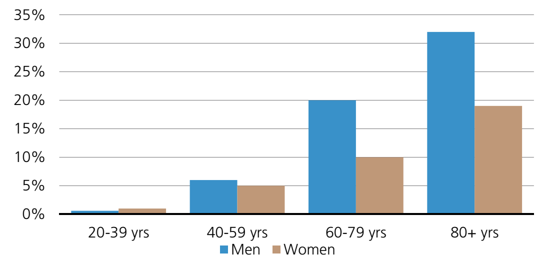
Source: National Center for Health Statistics, CDC. Note: Adults were categorized as having 0–1, 2–3, or 4 or more of the following chronic conditions: hypertension, coronary heart disease, stroke, diabetes, cancer, arthritis, hepatitis, weak or failing kidneys, chronic obstructive pulmonary disease, or current asthma.

Among the MCOs, we prefer those with strong positioning in the Medicaid and Medicare market because of their relatively higher growth potential. For the theme, MCOs with higher exposure to Medicare are most relevant. While government reimbursement restrictions in Medicare are always possible in the future, we argue that the government is less likely to do this because cost-effective health insurers are an attractive alternative for the government to manage and lower costs of the program.

Pharmaceuticals
Another potential beneficiary of an aging population is pharmaceutical companies that manufacture drugs aimed at prolonging or improving the quality of life for sufferers of chronic illnesses, such as cancer, Alzheimer's, diabetes, and heart disease, which are more prevalent in the elderly (Fig. 7). We favor companies with a strong pipeline of new drugs that should support future sales and margins. We see only a slim chance of major drug pricing proposals passing in Washington, especially with a Republican Congress.

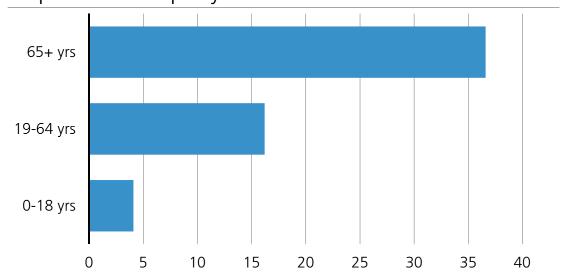
Medical supplies
We see some upside for select medical supply manufacturers. We prefer companies with a diverse and innovative product offering and would avoid those with undifferentiated products that are vulnerable to pricing pressure. In particular, we find medical suppliers specializing in products to treat cardiovascular disease well-positioned to benefit from an aging Boomer population (Fig. 8).

Fig. 8: Coronary heart disease is more common in older populations
Prevalence of coronary heart disease, in %



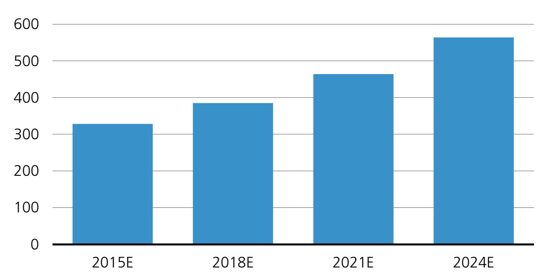
Source: American Heart Association, 26 January 2016

Fig. 9: Retail prescription utilization increases dramatically over the age of 65
Rx per member per year



Source: CVS, utilization based on CVS/caremark book of business; all prescriptions on a 30-day basis, excludes Aetna, as of December 2015

Fig. 10: US prescription drug expenditures are expected to grow
USD billions



Source: CVS, CMS, Office of the Actuary, as of 30 July 2015

Consumer staples

We expect an increase in demand for personal care products as Boomers combat the cosmetic effects of aging. We see certain cosmetics companies and pharmacies as potential beneficiaries.

Cosmetics

Companies that have a strong presence in anti-aging skin care and cosmetic lines targeting more mature customers may benefit from increased demand. We favor companies that lead within the global prestige cosmetics and skin care segments, including exposure to makeup, where we are seeing growth accelerate. Global positioning, particularly in Asian countries, is also an important differentiator as an aging population is not unique to the US.

Pharmacies

Pharmacies are another potential beneficiary of the aging Baby Boomer demographic. According to US Census Bureau estimates, more than 20% of the US population will be over the age of 65 by 2030. Individuals in this age bracket utilize prescriptions at more than twice the rate of their younger counterparts (defined as ages 19-64), based on CVS estimates (Fig. 9). As a result, the Centers for Medicare and Medicaid Services (CMS) projects that US prescription drug expenditures will to grow by more than 6% annually over the next 10 years (Fig. 10). Within the segment, we believe companies offering pharmacy benefit management services are well-positioned to capture share of increased drug spending. Pharmacy benefit managers play a role in helping to ensure that patients adhere to their medication regimens, which means more spending on prescription drugs, but lower healthcare costs overall.

Consumer discretionary

Outside of the necessities like healthcare and personal products, we also foresee changes in the Boomers' discretionary spending patterns as they age and seek to enjoy their "golden years". We expect an increase in experience-related spending that may benefit well-positioned companies in the travel & leisure, entertainment, and housing sectors. On a darker note, we also expect aging Boomers to start spending on end-of-life planning.

Cruising

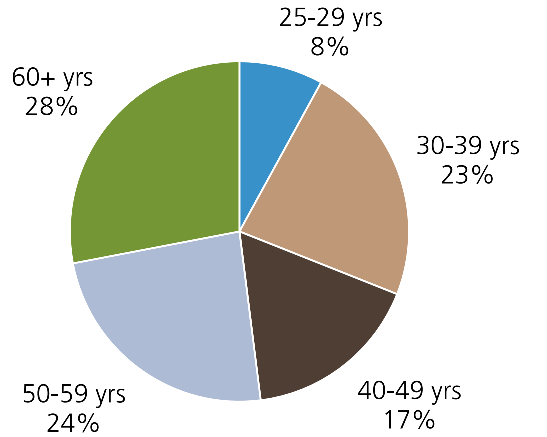
Cruise lines are well-positioned to capitalize on retired Baby Boomers interested in travel. This travel experience appeals to retirees who have large amounts of uninterrupted free time to explore. In fact, over 25% of cruise line passengers are over the age of 60 (Fig. 11). Moreover, the cruise lines represent a relatively under-penetrated vacation market, with a US penetration rate of only 3.5%.

Cruise lines are a high fixed cost business, which means operators manage yields (or adjust prices) in order to ensure full occupancy. Increased demand from this older demographic should be supportive of the pricing environment for cruises against a backdrop of highly visible supply increases.

The cruise liners we have selected benefit from substantial scale and have a strong portfolio of luxury cruise brands. These brands appeal to

Fig. 11: Cruises tend to appeal to an older subset of the population

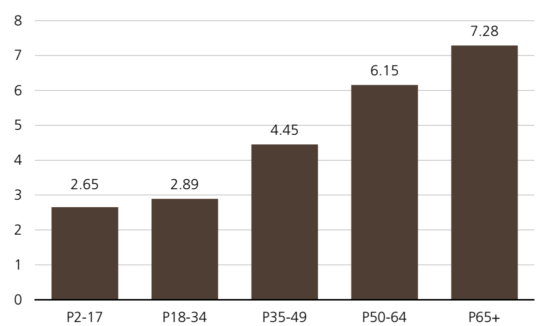
Percentage of cruise customers, by age group



Source: Cruise Lines International Association, as of January 2015

Fig 12: Baby boomers spend more time watching TV than younger demographics

Daily Time Spent with Traditional Television, by age group (Hours)



Source: Source: Nielsen NNTV, UBS; Time period data; Total Day M-Su 6a-6a 1/1/16-12/31/16 the wealthier segment of the Boomers who have more discretionary dollars to enjoy.

Senior living communities
As Boomers retire and become empty-nesters, they may consider changes to their living arrangements. For example, they may decide it's time to downsize and move to a retirement community that offers leisure activities catering to their demographic. These communities offer luxuries such as golf courses, pools, club houses and other amenities that appeal to individuals looking to enjoy their retirement years. We see an opportunity to invest in homebuilders that are industry leaders in developing lifestyle communities to serve active Baby Boomers as they move toward retirement.

Alternatively, health issues may require aging Boomers to move to communities that specialize in health services. These types of communities can offer services such as memory care, rehabilitation services, outpatient medical solutions, and general assisted living.

Entertainment
Based on Nielsen data, the over 65 segment of the population spends more time watching television each day than any other age segment. (Fig 12) We expect viewership from the Baby Boomer population to support the television broadcasters which cater to their demographic, despite competition from online video services and the millennials' shift away from traditional television.

Financials
As Baby Boomers age, their need for services to manage and administer their assets, finance their retirement years, and plan for the future of their heirs will increase – especially as life expectancies continue to rise. We see an opportunity to invest in diverse financial companies, trust companies, and asset managers that target an older demographic by specializing in retirement services or estate planning.

Asset managers
Asset managers are slated to benefit from the aging of the Baby Boomers. These companies maintain and manage individuals' assets in retirement to generate return and prevent loss of principal. Strategies can be utilized to help accumulate assets as well as plan to prevent outliving of existing assets. This will become increasingly in-demand as retirees leave the workforce and depend on financial returns to support their livelihood. Managing the assets of a third party is relatively risk free and does not require the assumption of significant proprietary risk. Lighter capital requirements and less balance sheet exposure make asset managers an appealing way to access the financial sector with relatively less risk than other subsectors.

Insurers
Different forms of insurance exist to protect against "longevity risk" (or the risk of outliving one's assets). Products, such as annuities, that convert a lump sum of savings into a fixed stream of income will appeal to individuals entering retirement as they no longer have work-related earnings.

Risks

There are some potential risks that could adversely affect the performance of our investment theme. First, given that a large portion of relevant companies is exposed to the healthcare sector, it is important to consider potential regulatory changes. In our view, the election result shifted the focus of concern about the health care sector from potential drug price regulation to the implications of a potential repeal of Obamacare. However, due to the current hold of repeal and replace, drug pricing may come back into focus. Next, portions of our investment case rest on the premise that the Baby Boomers will retire from the workforce and spend their assets in a predictable fashion. It is possible that the Baby Boomers will exhibit different discretionary spending patterns than past generations, or have different preferences than we would expect based on their generation's unique characteristics. The final risk is that an economic recession or poor financial market performance impairs Baby Boomers' ability to spend on discretionary items.

Appendix

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
A	actual i.e. 2010A	Shares o/s	Shares outstanding
CIO	UBS Chief Investment Office	x	multiple / multiplicator

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Version as per September 2017.