

# The Wealth Report

## Insights Into Leading Edge Wealth Trends

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### Attitudes & Indices

Rebounding markets pump up investor optimism in the near term for stocks. After taking a solid drubbing from early March through late April, the major averages rose sharply during the month of May. The S&P 500 gained 3.0 percent, and the Nasdaq rebounded an even higher 7.3 percent. Meanwhile, Spectrem Group's Affluent Investor Index (tracking the sentiment of individuals worth at least \$500,000) rose from zero in April to a borderline bullish reading of 10 in May. Millionaires among this group, more solidly bullish at a level of 16, have been bullish for the past eight months.

The wealthiest Americans, in contrast, see riskier days ahead and have taken a bearish stance on the stock market. U.S. Trust tracks the optimism of the wealthiest one percent of American households – those with adjusted gross incomes of more than \$300,000 a year or net worth greater than \$5.9 million. Year over year, this index plunged more than 25 percent from 66 to 48. It's the first slip in stock market optimism for this group since the survey started in 2002. Although 81 percent of respondents experienced gains from stock investments in 2004, more than 33 percent say the market is riskier today.

Both millionaires and the affluent place higher oil and gas prices among top worries, along with the war in Iraq and retirement, according to Spectrem. In a separate study of the wealthiest Americans by U.S. Trust, the biggest worry for the wealthy is the financial security of their children, given expectations of modest returns, rising inflation and higher college costs. This marks the first time since September 11, 2001 that terrorism was not the most prevalent concern.

While stocks look only so-so, real estate returns remain red hot for many, while others see now as a better time to be sellers. Even Federal Reserve Chairman Alan Greenspan acknowledged "froth" in certain housing markets, and some wealthy individuals are lightening up on portfolio allocations to real estate. Merrill Lynch and Capgemini report that the wealthy (defined as individuals with more than \$1 million in investable assets) held 13 percent of their assets in real estate investments in 2004, down from 17 percent in 2003. Also, total assets in real estate mutual funds in the U.S. fell by 0.5%, from \$43.9 billion at the end of 2004 to \$43.7 billion by April 2005. This would be consistent with "smart money" taking some profits in an overheated asset class.

Lots of leverage and the ability to sell without moving set up vacation property and other second homes for a nasty price correction, if the real estate market softens. Greenspan has pointed out before that the housing market is unlike the stock market. Transaction costs are high, both financial and in terms of aggravation from moving. But owners of second homes are unbridled from the inconvenience of moving and thus may be quicker to sell in a deteriorating market to lock in unrealized gains. More than one in three

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homes are second homes today, and in 2004, sales of vacation and investment properties kept up the pace, accounting for 36% of all home sales. The National Association of Realtors reports that 92 percent of second homebuyers see their property as “a good investment.” All in all, if you’re sitting on some solid real estate investment gains, it’s hard to argue against taking some money off the table, especially if your holdings are in markets repeatedly cited as being overheated, highly speculative, and less driven by fundamental supply-demand dynamics.

## **Wealth Demographics**

Just how many millionaires are there in the United States, anyway? Merrill Lynch and Capgemini, using data from 2004 in their just released *World Wealth Report 2005*, put the figure at 2.5 million, and say it grew 9.9 percent from 2003. Boston Consulting Group estimates there were 2.75 million U.S. millionaire households at the end of 2004, up 5.1 percent over 2003. Both counts exclude the value of a primary residence for determining worth. BCG excludes private equity investments, while Merrill Lynch and Cap Gemini value it at book value. There is agreement that millionaire household growth is continuing but slowing from double-digit percentage gains in 2003.

The graduation of these millionaires into higher levels of wealth is happening at an even faster pace. Households with a net worth of \$5 million or more grew 38 percent to 740,000 in the past year, according to Spectrem. Boston Consulting Group found that the number of U.S. households with assets under management of \$20 million or more has grown by 3,000 a year over the last three years, and totaled 40,000 at the end of 2004. Merrill and Capgemini say the “mid-tier millionaire” – with assets between \$5 million and \$20 million – is an “under-served group” caught between the mere millionaires below and the super rich above them. Wealth managers need to understand the evolving needs in this “middle market” for complex estate, philanthropic, and retirement planning services and design products and services that fit.

According to a report from McKinsey & Co., with the population aging well into the middle of the century, the prospect of a higher savings rate looks glum and casts doubt on the long-term viability of the wealth boom. As the boomers head into retirement, they will be drawing on their nest eggs, rather than adding to them, and younger generations in Japan, the United States, and Europe are proving to be less frugal. The potential fall in global savings and the decline in projected financial wealth could depress investment and slow economic growth. Congress and President Bush need to avert disaster with Social Security and Medicare reform – ideally by allowing individuals to save at least a portion of contributions in private accounts – and make a concerted effort to boost savings rates, shrink government deficits, increase returns on financial assets and put greater emphasis on preventive (instead of remedial) health care programs to avert this bleak outcome.

It’s in the self-interest of the wealthy to cultivate more wealthy people and to foster upward mobility. Much has been made of the widening gap between the fortunes of the rich and the poor over the past few years, but the situation *is* improving for those at the lower range of the wealth and income distribution. Federal money in exchange for school accountability has boosted spending per student and spotlighted educational performance. Education is one of the strongest catalysts for upward mobility, and disadvantaged

students benefit from higher academic standards. But they also need help in developing a winner's mindset and sharpening the soft skills of success like self-confidence and etiquette that they may not learn at home. Philanthropic gifts to schools and mentoring programs, as well as direct commitments of time on the part of wealthy individuals, are effective ways to give kids the tools to become wealthy.

## **Marketing and Advertising**

The online free content revolution is coming to an end, at least with credible players, since it is an unsustainable model. In a smart and long overdue move, the New York Times says it will begin charging non-subscribers \$50 per year for access to the newspaper's online edition and archives starting September 19. Companies that use free content to sell advertising or other products can be justly accused of delivering biased propaganda with conflicts of interest. The Times is doing the right thing. The wealthy are willing to pay for well-researched, high quality information.

Banks target the wealthy with loyalty programs beyond credit and debit cards and traditional banking services — but have they asked the wealthy what would make them truly loyal? Banks and other companies that target the wealthy try to use one-size fits all programs but seldom consult with their wealthy customers to see what they really want. Our recent Luxury Institute WealthSurvey found that while the wealthy like current rewards programs, 68 percent of households with incomes above \$2 million and 65 percent of households with a net worth of at least \$30 million want “surprise” rewards that are selected specifically for them. This is only possible if purveyors making the awards know their customers intimately, and most do not.

## **Wealth Management**

Alternative investments remain more popular than stocks with the wealthy. The Institute for Private Investors (IPI) found that in 2004, wealthy families (with more than \$10 million in assets) allocated 42 percent of their portfolios to hedge funds, private equity, venture capital and real estate, while just 37 percent was in stocks. Major wealth management firms advise a smaller allocation to alternative investments. JP Morgan advises clients with moderate risk tolerance to allocate up to 19 percent to alternatives. Citigroup counsels overseas clients to hold 22.5 percent in alternative investments. In any event, it's clear that the ultra-wealthy aren't looking to the stock market as their best approach for asset preservation or growth.

Amid weak returns and a proliferation of funds, hedge funds are attracting less new capital, but private equity picks up. Nearly half of the wealthy in the IPI study plan to invest more capital in private equity. Only 28 percent plan to increase their holdings in hedge funds – which are still the most popular alternative investment class – compared to 42 percent who were planning to add last year. Hedge Fund Research reports that hedge funds lost 0.7 percent through the end of April this year.

Angel investors and venture capitalists agree there is room for improvement in the way that angels and VCs work together. A George Washington University survey by Tony Stanco found that only 72 percent of angels believed that VCs considered them beneficial

to the venture capital industry, while in reality, 94 percent of VCs agreed said angels were helpful. Nonetheless, more than half of VCs surveyed conceded that prior angel involvement made a company an unattractive investment, and 58 percent of angels have had negative experiences with VC investments. Disagreements over company valuations or disputes over strategic direction and corporate organization can frequently erupt. Successful investments require both parties to accommodate the other as necessary links in the capital food chain.

## **Luxury Retail**

The Chinese luxury market is poised for ten-fold growth in the next five years, according to Bain & Co. With an estimated 236,000 Chinese millionaires at the end of 2004, China accounts for just one percent of the \$177 billion luxury goods market today. Bain expects China's share to reach 10 percent by 2010. Traveling Chinese prefer doing their shopping outside of Shanghai, where tariffs are high. Luxury firms targeting Chinese consumers have opened shops in Shanghai anyway, primarily for cultivating brand awareness that translates into sales elsewhere in the world.

A trend is emerging among leading luxury retailers building database marketing teams. Several top firms have discreetly launched credible pilot programs. The industry benchmark is Neiman Marcus' In-Circle program, which has 103,000 members purchasing an average of \$11,000 per year, and accounting for 50 percent of sales. The biggest challenges are collecting and maintaining the quality of customer data. Many luxury companies have no established discipline or methodology for doing so, leaving critical data collection to the discretion of store personnel or front-line staff. Although it is rarely acknowledged in the product and store-centric luxury retail world, relevant customer knowledge is the company's most critical asset. Developing incentive programs for staff and customers alike is essential in building a customer-centric business model.

Wealthy consumers are willing to provide data, but demand to know how it will enhance their customer experience, according to the Luxury Institute's recent WealthSurvey. The wealthiest households are especially demanding, with 85 percent of households earning \$2 million per year, and 83 percent of households with net worth of \$30 million plus, saying they need to know specifically how providing the data will be beneficial for them. Security is also a top-of-mind issue for wealthy consumers. Seventy-five percent of wealthy consumers say companies need to safeguard their data with the best security available. Women are more adamant than men, with 87 percent insisting on the best-in-class data security safeguards.

Ultra-luxury belts are becoming a major fashion statement, especially for men, but also for women, and luxury retailers will try to jump on the bandwagon. As in most categories, the pure-play, specialist brands – like JW Cooper in belts – will be the most successful in capitalizing on the trend. For Cooper, typical orders include an 18K gold buckle with farmed alligator skin for \$9,825, or a 14K yellow and white gold 3-piece buckle set with princess cut diamonds that goes for \$12,500. The premium belt trend makes sense, given the willingness of consumers to pay \$1,000 for jeans and shoes, or up

to six figures for a watch. Belts made of the finest skins with unique buckles are a logical extension of the desire to experience something special with what had been basic accessories.

Innovative luxury retailers will adapt membership models to build additional layers of exclusivity around their brands. In luxury, many membership models grew out of the fractionalization of jets, yachts, and real estate, but show signs of catching on – albeit in a different format – in luxury retail. For a \$2,000 initial membership fee and \$200 annual fee, Louis Vuitton’s CELUX membership program in Tokyo offers exclusive merchandise and events for members, such as champagne sipping and goods available only via CELUX membership. Look for the emergence of these clubs in the U.S., especially ones established through the collaboration of complementary brands, coming together to offer members a constellation of unique benefits and experiences from like-minded luxury purveyors.

### **Luxury Transportation**

Private jet travel becomes more accessible and less costly – but hassles are becoming more frequent as traffic soars and the IRS issues new regulations limiting the deductibility of jet travel for senior executives. AvData reports that there are currently 4,862 fractional owners, up about 250 percent from 1,903 in 1999. UBS says fractional owners flew 25 percent more in 2004 than in 2003. Delays and congestion are mounting, as the jet companies sell ever-smaller slivers of time with no long-term commitment (CitationShares now offers 20 hours for \$75,995). This has boosted the numbers of potential flyers and has caused sporadic scheduling problems.

The luxury jet market may be encountering some serious headwinds after its meteoric growth. The latest air headache: new IRS rules that require an executive flying on a company jet to pay income tax on the fair market value of an equivalent charter for the cost of the travel to be deductible for the employer. This would be a big tax bite for executives, and the net result will be the loss of deductibility for executive travel.

Lexus retains the top spot on JD Power’s quality survey, but it’s still miles behind Mercedes and BMW in exclusivity, according to the Luxury Institute’s Luxury Brand Status Index Survey for automobiles. Based on responses of wealthy consumers in multiple categories, Lexus comes in 6<sup>th</sup> in exclusivity, 5<sup>th</sup> in social status, 5<sup>th</sup> in making the customer feel special, and 5<sup>th</sup> in meriting a significant price premium. However, Lexus is on the rise, rated first by the Luxury Institute on being the brand whose status as a luxury brand has significantly increased in the past 12 months. Lexus took top honors in quality from both JD Power & Associates and the Luxury Institute. Mercedes and BMW were able to overcome quality control issues and vault back into the top five of the brands in the JD Power quality report.

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### **About the Luxury Institute**

The Luxury Institute is an in-depth research, subscription-based organization that focuses solely on the top 10% of America's wealthy. The firm provides a portfolio of publications that guide and educate high net-worth individuals and the companies that cater to them on leading edge trends, consumer rankings and ratings of luxury brands, and best practices. Publications include the monthly Wealth Report, the Luxury Brand Status Index surveys, and the Luxury Best Practices surveys. To reach the Luxury institute, please call 646-792-2669 or go to [www.luxuryinstitute.com](http://www.luxuryinstitute.com).

The Luxury Institute has just published its latest Luxury Brand Status Survey for Wealth Managers, Private Jet Services and Ultra-Luxury Automobiles. For more information please contact Mr. Martin Swanson at [mwsanson@luxuryinstitute.com](mailto:mwsanson@luxuryinstitute.com) or at 914-909-6350

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