

McKinsey Global Institute



December 2011

The emerging equity gap: Growth and stability in the new investor landscape



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The emerging equity gap: Growth and stability in the new investor landscape

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Global financial assets today . . .

\$198 trillion

Total value of global financial assets in 2010,

21% in emerging economies

\$85 trillion

financial assets held by households (excluding retirement accounts and insurance products)

15% of emerging market household portfolios are invested in equities, compared with

42% in US households

... and tomorrow

\$371 trillion

Projected value of global financial assets in 2020,¹ with

30% in emerging economies

22% Estimated share of global financial assets in listed equities in 2020, down from

28% in 2010

\$12.3 trillion

Potential global “equity gap” in 2020

Executive summary

Several forces are converging to reshape global capital markets in the coming decade. The rapid accumulation of wealth and financial assets in emerging-market economies is the most important of these. Simultaneously, in developed economies, aging populations, growing interest in alternative investments, the move to defined-contribution pension schemes, and new financial regulations are changing how money is invested. These forces point to a pronounced rebalancing of global financial assets in the coming decade, with a smaller share in publicly listed equities.¹

This emerging picture is based on new research by the McKinsey Global Institute on the size, growth, and asset allocations of investor portfolios around the world. This work complements our previous reports on deleveraging in the world's major economies and the effects of an investment boom in emerging markets on real interest rates in coming decades.² In this report, we develop new insights into how the world's financial assets are growing and being invested, and how these assets could evolve over the next decade. Among our key findings:

- Today, investors in developed economies hold nearly 80 percent of the world's financial assets—or \$157 trillion—but these pools of wealth are growing slowly relative to those in emerging markets.
- The financial assets of investors in emerging economies will rise to as much as 36 percent of the global total by 2020, from about 21 percent today. But unlike in developed countries, the financial assets of private investors in these nations currently are concentrated in bank deposits, with little in equities.
- Several factors are reducing investor appetite for equities in developed countries: aging populations; shifts to defined-contribution retirement plans; growth of alternative investments such as private equity; regulatory changes for financial institutions; and a possible retreat from stocks in reaction to low returns and high volatility.
- Based on these trends, we project the share of global financial assets in publicly traded equities could fall from 28 percent today to 22 percent by 2020. That will create a growing “equity gap” over the next decade between the amount of equities that investors will desire and what companies will need to fund growth. This gap will amount to approximately \$12.3 trillion in the 18 countries we model, and will appear almost entirely in emerging markets, although Europe will also face a gap.

1 In this report, we use the terms “equities” and “stocks” to refer to shares in publicly listed companies, not the unlisted equity in privately- or government-owned companies.

2 See McKinsey Global Institute, *Debt and deleveraging: The global credit bubble and its economic consequences*, January 2010, and *Farewell to cheap capital? The implications of long-term shifts in global investment and saving*, December 2010. These reports are available online at www.mckinsey.com/mgi.

- As a result, companies could see the cost of equity rise over the next decade and may respond by using more debt to finance growth. Only a tripling of equity allocations by emerging market investors could head off this drop in demand for equities—which will be difficult to accomplish in this time-frame, given the remaining institutional barriers. The probable outcome is a world in which the balance between debt and equity has shifted.

The implications of this shift are potentially wide ranging for investors, businesses, and the economy. Companies that need to raise equity, particularly banks that must meet new capital requirements, may find equity is more costly and less available. Reaching financial goals may be more difficult for investors who choose lower allocations of equities in their portfolios. And, with more leverage in the economy, volatility may increase as recessions bring larger waves of financial distress and bankruptcy. At a time when the global economy needs to deleverage in a controlled and safe way, declining investor appetite for equities is an unwelcome development.

Today, the advantages of investing in listed equities are being questioned in light of corporate scandals and a perception that the markets may no longer serve the interests of ordinary investors.³ But equity markets, when functioning properly, provide significant benefits across an economy. They are an important source of long-term financing for high-growth companies; they allocate capital efficiently; and they disperse risk and reduce vulnerability to bankruptcy. These advantages outweigh shortcomings, we believe, and make public equity ownership an important element of a balanced global financial system.

GLOBAL WEALTH IS SHIFTING TO EMERGING ECONOMIES

Until this decade, the preferences of investors in developed nations have shaped the evolution of global capital markets. Today these investors control 79 percent of the world's nearly \$200 trillion in financial assets (Exhibit E1).⁴

Broadly speaking, investors in developed economies hold highly diversified portfolios, with significant portions in equities. The United States stands out for consistently high equity allocations: currently US households have 42 percent of their non-retirement financial assets in publicly listed shares. Households in Hong Kong have similar shares of their wealth in equities. On average, Western European households placed 29 percent of their financial assets in equities in 2010.

Among developed nations, Japan stands out for its very low investment in equities. Despite a long tradition of equity investing by individual investors for most of the 20th century, Japanese households now hold less than 10 percent of their assets in equities, down from 30 percent before the 1989–90 crash. Because of low or negative returns over the past two decades, Japanese allocations have never exceeded 18 percent in this period.

³ See Dominic Barton, "Capitalism for the long term," *Harvard Business Review*, March 2011.

⁴ We define financial assets as equities, bonds, and other fixed-income securities, cash and bank deposits, and alternative assets. We exclude the value of real estate, derivatives, physical assets such as gold, and equity in unlisted companies.

Exhibit E1**Investors in developed countries hold the majority of global financial assets**

Financial assets owned by residents, 2010

\$ trillion

	United States	Western Europe	Japan	China	Other developed ¹	Other Asia ²	Latin America	MENA	Rest of world	Total
Households	27.0	23.0	11.6	6.5	4.1	5.4	3.5	2.7	1.4	85.2
Institutional investors	15.0	5.3	3.3	0.5	2.4	0.6	0.7	0.4	0.1	28.3
▪ Pensions ³										
▪ Insurance	6.6	9.6	3.5	0.6	0.7	1.0	0.3	0.1	0.3	23.0
▪ Endowments & foundations	1.1	0.2	0.0	--	0.1	--	0.0	0.0	--	1.5
Corporations	4.0	11.9	6.7	3.9	1.4	0.9	0.9	0.5	0.5	30.7
▪ Banks										
▪ Nonfinancial corporations	2.0	1.7	1.2	3.8	0.3	1.3	0.3	0.2	0.2	11.0
Governments	2.3	1.7	1.0	2.5	0.2	1.9	0.5	0.4	1.5	12.0
▪ Central banks										
▪ Sovereign wealth funds	0.1	0.6	--	0.7	0.1	0.9	0.1	1.7	0.2	4.3
▪ Other government	--	--	--	1.1	--	0.4	0.5	0.3	0.1	2.4
Total	58.1	54.0	27.3	19.8	9.3	12.4	6.8	6.3	4.3	198.1

1 Includes Australia, Canada, and New Zealand.

2 Includes both developed countries and emerging markets.

3 Includes defined contribution plans and individual retirement accounts (IRAs).

NOTE: Numbers may not sum due to rounding.

SOURCE: National sources; McKinsey Global Institute

Emerging market financial assets grew 16.6 percent annually over the past decade, nearly four times the rate in mature economies. These assets stood at about \$41 trillion in 2010 and constituted 21 percent of the global total, up from 7 percent in 2000. Depending on economic scenarios, we project that emerging market financial assets will grow to between 30 and 36 percent of the global total in 2020, or \$114 to \$141 trillion (Exhibit E2).⁵ China's financial assets could be as much as \$65 trillion by then, and India's could reach \$8.6 trillion.⁶

With this growth, emerging markets will become an increasingly important force in determining the shape of the global financial system. Emerging market investors keep most of their assets in bank deposits (Exhibit E3),⁷ which reflects lower income levels, underdeveloped financial markets, and other barriers to diversification. A key question for the future of global financial markets is the speed and extent to which investors in these countries will develop a larger appetite for equities and other financial instruments and diversify their portfolios.

5 Our base case consensus growth scenario and the two-speed recovery scenario use 2010 exchange rates, and so do not include impact of currency movements on asset values. We model the effects of likely currency in an alternate scenario. See Appendix for additional detail on the scenarios.

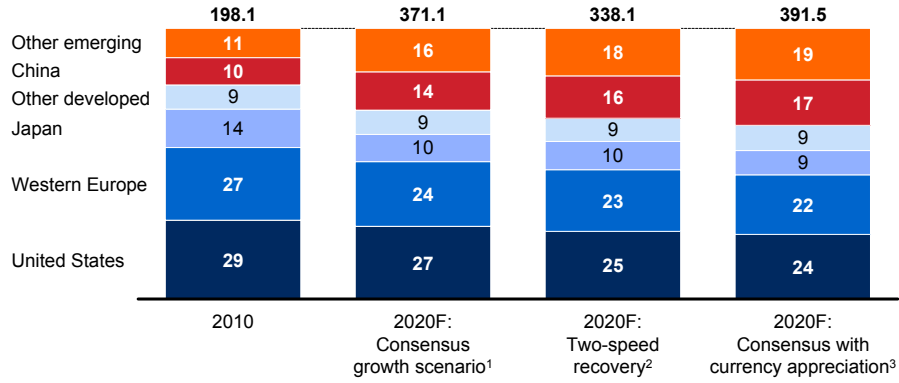
6 This high estimate includes the impact of appreciation of the renminbi and other emerging market currencies over the next decade

7 Moreover, in many emerging markets, a large share of wealth is held in physical assets, such as real estate and gold. See Alok Kshirsagar and Naveen Tahilyani, *Deepening financial savings: Opportunities for consumers, financial institutions, and the economy*, McKinsey & Company, November 2011.

Exhibit E2

The share of global financial assets held in emerging markets will rise over the next decade in all economic scenarios

Total financial assets, 2010–20F
%; \$ trillion



Emerging markets' financial assets
\$ trillion

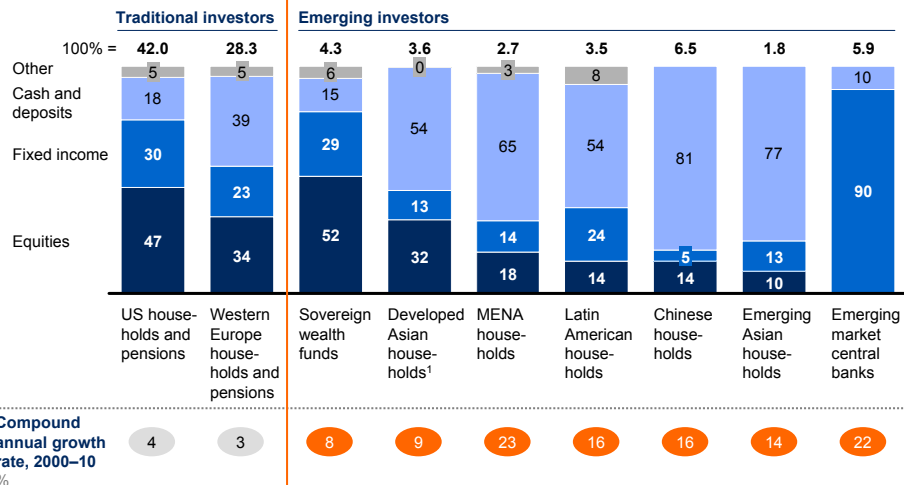


1 Measured in 2010 exchange rates.
2 Rapid growth in emerging markets but low growth through 2015 in mature economies.
3 Emerging markets' currencies appreciate vis-à-vis the US dollar.
SOURCE: McKinsey Global Institute

Exhibit E3

Today, most investors in emerging markets have very low allocations to equities

Asset allocation by investor, 2010
%; \$ trillion



1 Includes Singapore, Hong Kong, Korea, and Taiwan. Excludes Japan, where households allocate 10% of their portfolio to equities.
SOURCE: National sources; McKinsey Global Institute

Over the past century, there has been a clear pattern: with few exceptions, as countries have grown richer, investors have become more willing to put some money at risk in equities to achieve higher rates of return. We have seen this pattern not only in the United States and Europe, but more recently in Singapore, South Korea, and Hong Kong. However, other factors must also be in place for equity markets to thrive: rules and regulations that protect minority investors, transparency by listed companies, sufficient liquidity in the stock market, the presence of institutional investors, and easy access to markets by retail investors.

Today, most emerging markets lack these conditions. Exchanges are often dominated by state-controlled companies with only a small portion of their shares trading publicly, exposing investors to high levels of volatility. Even where appropriate regulatory frameworks have been erected, enforcement often has been weak. Limited visibility into corporate performance and little accountability to public shareholders put outside investors at a further disadvantage. Not surprisingly, in a recent survey, more than 60 percent of investors in emerging Asian economies said they prefer to keep savings in deposits rather than in mutual funds or equities—a figure that has changed little over the past decade.⁸

WHY INVESTOR DEMAND FOR EQUITIES MIGHT DECLINE IN DEVELOPED ECONOMIES

Aging is the largest factor affecting investor behavior in mature economies. As investors enter retirement, they typically stop accumulating assets and begin to rely on investment income; they shift assets from equities to bank deposits and fixed-income instruments. This pattern has led to predictions of an equity sell-off as the enormous baby boom generation in the United States and Europe enters retirement⁹ (the oldest members of this cohort reached 65 in 2011). We find this fear is somewhat exaggerated, but the effects of aging are real: if investors retiring in the next ten years maintain the equity allocations of today's retirees, equities will fall from 42 percent of US household portfolios to 40 percent in 2020—and to 38 percent by 2030. In Europe, where aging is even more pronounced, we see an even larger shift in household portfolios.

Also influencing equity allocations in mature economies are the shift to defined-contribution retirement plans in Europe and rising allocations to alternative investments. In Europe, we see that defined-contribution plan account owners allocate significantly less to equities than managers of defined-benefit plans. And as private pension funds close to new contributors, managers are shifting to fixed-income instruments to meet remaining liabilities. Meanwhile, institutional investors and wealthy households seeking higher returns are shifting out of public equities and into “alternative” investments such as private equity funds, hedge funds, real estate, and even infrastructure projects. Although we estimate that some 30 percent of assets in private equity and hedge funds are public equities, the shift is still causing a net reduction in allocations to equities.

Another factor weighing on demand for equities is weak market performance. The past decade has brought increased volatility and some of the worst ten-year returns on listed equities in more than a century. In opinion polls, Americans say they have less confidence in the stock market than in any other financial institution and believe that the market is no longer “fair and open.”¹⁰ However, to put these sentiments in perspective, it is also worth noting that individual investors can have short memories and may be willing to return to equities in the event of an extended rally.

8 See Kenny Lam and Jatin Pant, “The changing face of Asian personal financial services,” *McKinsey Quarterly*, September 2011.

9 See James Poterba, “Demographic structure and asset returns,” *Review of Economics and Statistics*, Volume 83, Number 4, 2001, 565–584. Also see Zheng Liu and Mark M. Spiegel, “Boomer retirement: Headwinds for US equity markets?” Federal Reserve Bank of San Francisco, *FRBSF Economic Letter*, Number 26, Federal Reserve Bank of San Francisco, August 22, 2011.

10 See Paola Sapienza and Luigi Zingales, Financial Trust Index, Results, Wave 12, October 19, 2011, and NBC News/Wall Street Journal, Study Number 10316, May 2010.

The final factor is the effect of financial industry reforms on the uses of equities by banking and insurance companies. US and European banks today hold \$15.9 trillion of bonds and equities on their balance sheets. But new capital requirements under Basel III will prompt banks to shed risky assets, including equities and corporate bonds. Similarly, European insurers have already reduced equity allocations in anticipation of new rules, known as Solvency II, and could lower them further over the next five years. At a time when European banks need to raise more capital, Solvency II constrains the insurance sector as a potential purchaser of that equity.

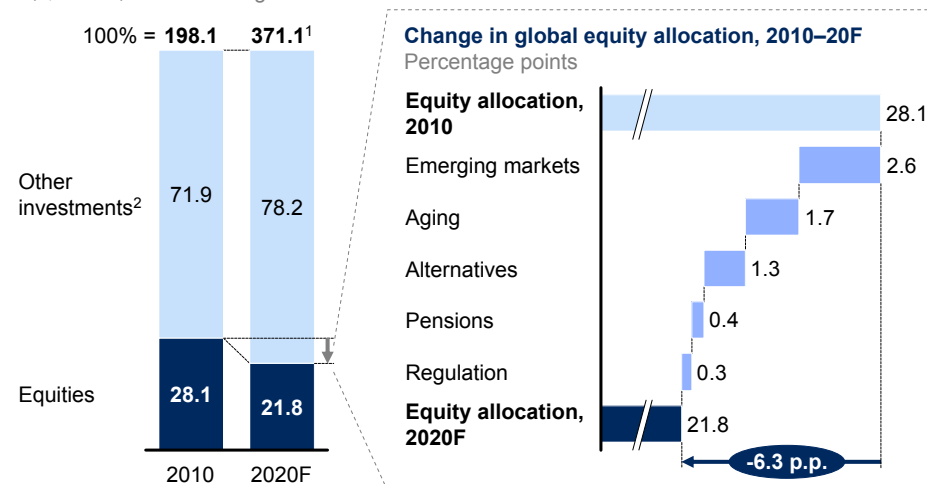
THE EMERGING EQUITY GAP

As a result of shifting global wealth and investor behavior, we estimate that by 2020 investors around the world may allocate just 22 percent of their financial assets to equities, down from 28 percent today (Exhibit E4). The rise of wealth in emerging nations is the largest factor in this shift, followed by aging populations and growth of alternative investments.

Exhibit E4

In our baseline scenario, equities decline from 28 percent of financial assets to 22 percent by 2020

Global asset allocation, 2010–20F
%; \$ trillion; 2010 exchange rates



¹ Based on consensus global growth scenario.

² Includes cash, deposits, and fixed-income securities.

SOURCE: McKinsey Global Institute

This trend away from equities will affect how companies are funded. Even though total investor demand for equities would still grow by more than \$25 trillion over the next decade in our base case scenario,¹¹ this demand would not be sufficient to cover the amount of additional equity that corporations will need. Companies issue shares to support growth and to allow founders, venture investors, and other insiders to monetize their shares. Using a sample of ten mature economies and eight emerging markets,¹² we calculate that companies will need to raise \$37.4 trillion of additional capital to support growth. This would exceed investor

¹¹ This scenario uses consensus forecasts for GDP growth and saving rates, and country-specific historic rates of asset appreciation. It allows for changing asset allocations due to aging, regulatory changes, and shifting investor tastes toward alternative investments. See Appendix for details.

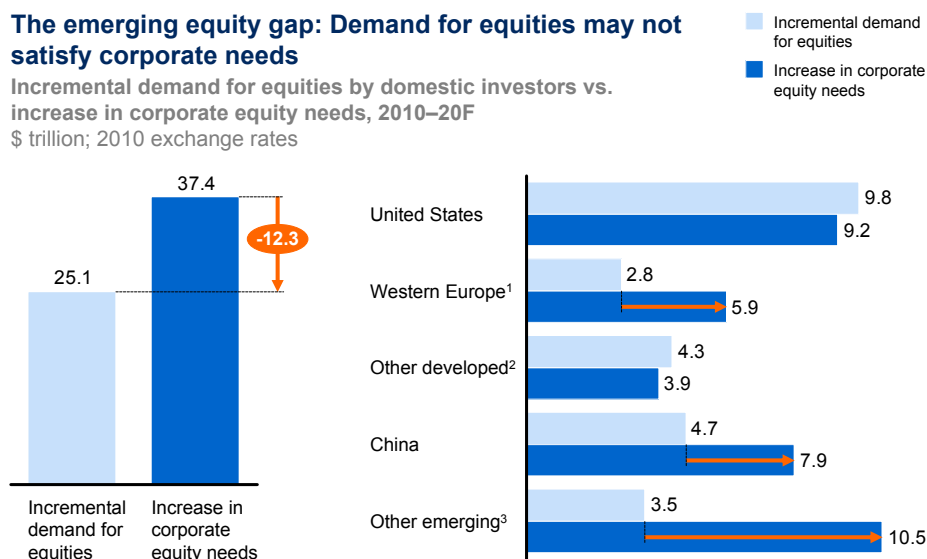
¹² Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, South Africa, South Korea, Spain, Turkey, United Kingdom, and United States.

demand in those countries by \$12.3 trillion (Exhibit E5). Eventually, markets will move to correct this imbalance: equity prices may fall and returns may rise to stimulate investor demand, or companies may use more debt and less equity to fund growth. Nevertheless, this change in demand would represent a significant reduction in the role of equities in the global financial system.

Exhibit E5

The emerging equity gap: Demand for equities may not satisfy corporate needs

Incremental demand for equities by domestic investors vs. increase in corporate equity needs, 2010–20F
\$ trillion; 2010 exchange rates



1 France, Germany, Italy, Spain, and the United Kingdom.

2 Australia, Canada, Japan, and South Korea.

3 Brazil, India, Indonesia, Mexico, Russia, South Africa, and Turkey.

SOURCE: McKinsey Global Institute

Most of the emerging equity gap would occur in developing nations. Companies in those countries not only have high needs for external funding to keep up with their rapid growth, but they also have relatively low returns on invested capital (ROIC), which limits their ability to use retained earnings to fund growth. In addition, many large companies, both privately owned and state owned, will seek to list on stock exchanges and issue shares. In Europe, a smaller equity gap would appear, as a result of declining investor appetite for equity, aging, and rising needs for new equity by banks.

In the United States and several other developed countries, investor demand for equities will most likely continue to exceed what companies will need because many companies in these economies generate sufficient profits to finance investment needs. Indeed, US companies at the end of 2010 had more than \$1.4 trillion in cash, and over the past decade nonfinancial corporations have been buying back shares, rather than issuing new ones.¹³

Changes on several fronts could narrow the gap between corporate needs and investor desire for equity. Households in the large equity investing countries could be encouraged to save more and overcome “home bias” to purchase more foreign equities. In addition, corporations, particularly in emerging markets, could become more efficient users of capital, enabling them to fund more of their growth through retained earnings. Finally, emerging market investors could rapidly develop a larger appetite for equities. We calculate that if emerging market

¹³ See McKinsey Global Institute, *Mapping global capital markets 2011*, August 2011 (www.mckinsey.com/mgi).

investors were to raise their equity allocations to current US levels over the next decade, global investor demand for equities would match corporate needs. However, such a sudden shift in investor preferences would be unprecedented and would require rapid evolution of institutions, market access mechanisms, and practices that make markets attractive to individuals seeking long-term appreciation.

ECONOMIC CONSEQUENCES AND IMPLICATIONS FOR COMPANIES AND INVESTORS

A shift away from equity in the global financial system is an important trend and, in our view, an unwelcome one. Equity markets have enabled growth by efficiently channeling money to the best-performing companies, including rapidly growing enterprises that drive economic growth. Although the debate over the relative merits of equity finance versus debt financing is not settled, the most persuasive empirical evidence suggests that if legal protections for shareholders are strong, financial systems that include robust capital markets in addition to bank financing promote faster and more stable economic growth than predominantly bank-based ones.¹⁴

Moreover, at a time when the global economy still struggles to recover from the collapse of the credit bubble, greater use of debt—whether from banks or through capital markets—would be an unwelcome development. Public equities disperse corporate ownership and give companies resilience in downturns; equity is a highly effective “shock absorber.” By contrast, higher leverage increases the risk of bankruptcy and economic volatility and makes the world economy more vulnerable to shocks.

As their allocations to equity decline, ordinary investors may find it more challenging to meet saving goals. Institutional investors and wealthy families have many options to generate high rates of return—private equity, hedge funds, real estate—but retail investors do not. We find that the poor equity returns of the past decade are anomalous. For almost all ten-year periods in the modern era—except in Japan—equities have generated significantly higher real returns than bonds.

Many companies are likely to find that they are unable to raise enough equity in their home countries or can do so only at high cost. Banks, particularly in Europe where investor demand for equities is weak, may find it challenging to find buyers for all the additional equity capital they need to raise. All companies will want to think about sourcing capital globally by listing in markets where investors’ demand for equities is strong, or through private placements of equity shares.

At the same time, shifting patterns of global wealth will create opportunities and challenges for the asset management industry and for investors. Asset managers will need an increasingly global reach to cultivate the emerging investor classes of Asia and other regions, which will require tailored products to fit their preferences and budgets. In mature markets, aging and low returns present growth challenges. However, there are unmet needs, too: the industry can profit by educating investors about the financial implications of longer life spans, including the need to get higher returns over a longer period. In this vein, some asset managers may need to redesign target-date mutual funds if they reduce

¹⁴ See Thorsten Beck and Ross Levine, “Industry growth and capital allocation: Does having a market- or bank-based system matter?” *Journal of Financial Economics*, 2002.

or eliminate equities too early to meet the ongoing accumulation needs of clients today.

Investors around the world will need to think more globally. Today investment portfolios remain disproportionately skewed toward investors' home markets. Investors in developed countries can tap faster pockets of economic growth by buying foreign shares or shares of multinational companies that are active in fast-growing markets. The challenge will be to find sources of return commensurate with the risk—and to find good values. Today, with the limited amount of shares in emerging market companies available to public investors, valuations can be distorted.

POLICY OPTIONS TO CONSIDER

We propose that business leaders and policy makers around the world consider a range of options to ensure that the potential equity gap does not emerge and that the world economy is set on a more stable, more sustainable course.

Emerging markets. Emerging economies can create the conditions in which healthy equity investing cultures can take root. They can strengthen listing requirements, ensure that securities regulations require full transparency by issuers, and provide meaningful protections to minority shareholders. Emerging market officials should also use regulatory changes and incentives to encourage faster expansion of institutional investors, such as pensions and insurance companies. They also can encourage development of more channels for equity investing by households.

Developed countries. As we have argued in previous reports, increasing the saving rate in the United States and other developed nations is an important step for ensuring long-term growth and rebalancing the global economy. Increasing saving overall would also increase flows into equities in these nations. More tax incentives for saving, automatic enrollment in retirement plans (with the right to opt out), and changes in the default allocation are all proven saving boosters. Additionally, we would look into removing tax biases that favor corporate use of debt over equity and reducing management incentives that reward buybacks and higher leverage. Finally, policy makers should also consider measures to revive the IPO market, such as expanding the streamlined registration process for small firms or creating a more robust legal framework for “crowdfunding.” Enabling small-company listings is important for maintaining a vibrant equity culture that attracts investors.

Global policy makers. The free flow of capital between nations will be even more important in a time of limited demand. To enable global capital flows, emerging nations need to allow greater access to their equity markets while protecting themselves from the ebb and flow of “hot money.” Ultimately, the best protection—and the best way to attract investment—is to develop broad and deep financial markets and credible oversight. To overcome home bias by investors, nations can remove limits on overseas investing. Access to currency hedging instruments and financial education about global diversification would also help investors raise their allocations of foreign equities. Finally, international regulatory bodies should carefully consider the cumulative impact of new regulations

affecting banks and other financial institutions, as these may have unintended consequences.¹⁵

□ □ □

Governments and business leaders share a common interest in expanding the supply of equity to the world economy. More equity will promote more stable and possibly more rapid growth. Many steps that could reverse the current trends against equities are well understood. Action now will ensure that the potential equity gap does not emerge, and put the world economy on a more stable, more sustainable course.

¹⁵ See, for example, Ahmed Al-Darwish et al., "Possible unintended consequences of Basel III and Solvency II," IMF Working Paper Number 11/187, August 2011.

Related McKinsey Global Institute publications



Debt and deleveraging: The global credit bubble and its economic consequences (January 2010)

The bursting of the great global credit bubble has left a large burden of debt weighing on many households, businesses, and governments, as well as on the broader prospects for economic recovery in countries around the world. Leverage levels are still very high in ten sectors of five major economies. If history is a guide, one would expect many years of debt reduction in these sectors, which would exert a significant drag on GDP growth. Read updated analysis and 2010 report.



Farewell to cheap capital? The implications of long-term shifts in global investment and saving (December 2010)

By 2020, half of the world's saving and investment will take place in emerging markets, and there will be a substantial gap between global investment demand and the world's likely saving. This will put upward pressure on real interest rates and require adjustment by financial institutions, nonfinancial companies, investors, and policy makers.



Mapping global capital markets 2011 (August 2011)

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December 2011
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