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Time to go global

Michael Nairne, Serious Money

Alex Domanski, Reuters Files

With Canadian stocks looking expensive and the commodity bull run looking tired Michael Nairne suggests going global. Germany's DAX index for example has gained 8.86% year-to-date, compared with 3.35% for the S&P-TSX composite index.

It is a heady time for Canadian investors. Our banks avoided the meltdowns experienced by many financial institutions in the global credit crisis. Demand for our commodities is skyrocketing. Canadian federal government bonds are rated a rock solid AAA. The loonie, once mocked as the northern peso, is riding high.

It's no wonder that foreign investors see Canada as a safe haven. Likewise, many Canadian investors have retreated from the global perspective of the 1990's and have shifted their equity allocations back to Canada. In 2000, Canadian investors had about 40% of their broadly diversified equity funds allocated to Canada. At the end of last year, this allocation had climbed to 62% while U.S. and global equities had dwindled to 38%.

You can't really blame investors for recoiling from global equity investing. It has been a painful experience over the past decade. From 2001 to 2010, the respective annual losses of the S&P 500 and MSCI EAFE indices were -2.7% and -0.3%, the consequence of two deep bear markets and the soaring loonie. In contrast, staying at home was rewarded - the S&P/TSX Composite was up 6.6% annually.

Unfortunately, this experience obscures some important fundamentals. There are five reasons why Canadian investors need meaningful global equity allocations.

The first is strategic - global diversification offers the opportunity for superior, risk-adjusted returns. Over the past 40 years, a portfolio comprised of 1/3 each of Canadian, U.S. and international equities not only earned 10.7% annually, beating the 10.2% return of the Canadian stocks, but it did so with nearly 20% less volatility. Modern finance's enduring lesson is that diversification works for the patient investor.

Second, Canadian stocks are more expensive than those of the United States and most other developed countries; a reversal of the situation a decade ago. Wegel & Co., a Swiss private bank, just released their assessment of the relative expensiveness and long-term expected real returns of the developed country stock markets. This isn't just another guru's opinion-they use a valuation method developed by finance professor, Robert Shiller, which has been proven to have reasonable long-term predictive power. Wegel ranked Canada as the second most expensive market with an expected annual real return of only 4.4%. In contrast, the expected real return for global equities is forty percent higher at 6.2% annually. Many European countries are in the 7% to 8% range. Canada is no longer a bargain.

Third, the Canadian market is increasingly an aging commodity play. Energy and materials stocks now constitute over 50% of the TSX's capitalization. Every commodity cycle ends as incremental demand slows in the face of rising prices and supply. Maybe not next year or even in a few years but this cycle will end. And watch out when it does. Everybody seems to have forgotten that materials stocks earned only 3.2% a year in the 1990's.

Fourth, the loonie looks expensive. Now around $1.05 vs. the U.S. dollar, it is much higher than its US88¢ average since 1950. It is also higher than values based on purchasing power parity which range from around US82¢ to the low US90¢'s. When the commodity boom ends so will the high-flying loonie.
Finally, the developing countries are now fuelling global growth. A Goldman Sachs report forecast that emerging markets will grow from 13% of the global stock market to 19% in 2020 and 31% in 2030. In my experience, affluent Canadians are woefully underinvested in emerging market equities.

Seneca, the Roman philosopher said, "Every new beginning comes from other new beginning's end."

The "Canadian" theme is getting long on the tooth. It's time to go global.

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