FINANCIAL POST

Wednesday, November 28th, 2012

Wealthy investors go global

Michael Nairne, Serious Money

Behavioural finance experts have discovered that investors worldwide overweight their own country's stocks while underweighting foreign equities. Chloe Cushman for National Post

What do Canada's largest pension plans, major U.S. endowments and wealthy families have in common?

They have taken their portfolios global by allocating an increasing share of their equities to foreign versus domestic stocks. Canada's five largest pension plans have a particularly striking mix. On average, they allocate 71% of their public equities to U.S., international and emerging markets and only 29% to Canada itself. This is the opposite of Canadian fund investors, who still have the majority of their equities invested domestically.

Retail investors in Canada have long been traumatized by the abysmal performance of foreign equities. The tech crash followed by the global credit crisis, together with the added pain of a soaring loonie, have left investors in U.S. and international stocks bought at the turn of the millennium still in the red. The 5.4% annualized return of the S&P/TSX composite index practically sparkles in comparison.

There is another reason Canadians are so heavily invested domestically. Behavioural finance experts have discovered that investors worldwide overweight their own country's stocks while underweighting foreign equities. This phenomenon — coined "home bias" — reflects the fact that people are more comfortable investing in local companies in their own economy. Interestingly, studies have found that the more experienced and knowledgeable investors are, the less prone they are to home bias.

Unfortunately, home bias forsakes the benefits of global diversification. For long-term investors, these are compelling. Since 1970, a portfolio allocated equivalently to Canadian, U.S. and international stocks has earned an annualized return of 9.9%, outpacing all of the individual markets, including Canada's.

However, the case for global diversification doesn't rest solely on the potential for higher returns. It is also about risk management. The globally diversified portfolio was less volatile than one invested solely in Canada; in fact, Canadian stocks were actually the most volatile of all three regions, as evidenced by the higher standard deviation (a measure of the degree of variation from the average return).

This heightened volatility traces primarily to Canada's high sector concentration. Three sectors — financials, energy and materials — account for more than 75% of the Canadian market. In contrast, the top three sectors of the S&P 500 — information technology, financials and health care — comprise less than 50% of the U.S. market.

Volatility is just one dimension of risk. A second and perhaps more troubling aspect is a prolonged period of underperformance relative to other regional stock markets. Lulled by Canada's relative outperformance so far this millennium, many investors may be unaware of this risk.

Canada's stock market outperformance since 2000 traces to superior economics for all three of its major sectors. Canada's banks benefited from their push into the investment industry, robust mortgage and consumer loan demand and their resilience in the global credit storm. The energy industry received a boost from a more than threefold increase in oil prices. Gold stocks, which now constitute more than 10% of the Canadian market, were lifted by a sixfold increase in gold prices.

Looking forward, there are question marks surrounding all of these sectors. Canadian banks must look to the highly competitive U.S. and international markets for growth. Technological innovation and environmental issues are changing the landscape for energy. Even the most ardent gold bugs aren't forecasting another sixfold price increase soon while mining costs are soaring.

There are other reasons to invest globally. Stocks in Europe and Asia are much cheaper than in Canada. At the same time, the growth prospects for the emerging markets far exceed Canada's. Meanwhile, our currency sits well above its long-term average of US88¢, creating the potential for currency gains in coming years.

History would suggest that Canada can't lead forever. For the 10 years ended 1990, international stock returns of 16.7% a year far outpaced the 7.6% return of Canadian stocks. By 2000, the U.S. market's 10-year return of 20.5% a year was light-years ahead of Canada's 13.1%. Given yesteryear's experience, wealthy investors are diversifying globally today to avoid the risk of underperformance tomorrow.

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto. Visit tacitacapital.com