INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

Going global reduces volatility

This strategy also provides healthy returns

March 2010 Print Edition

By Michael Nairne

The superior performance of the Canadian stock market relative to its global counterparts over the past decade has left some financial advisors doubting the wisdom of global equities diversification.

Assets under management in foreign equity mutual funds slipped to just 11.8% of total mutual fund assets in 2009 from 28.2% in 2000. Yet, based on a historical analysis (in Canadian dollars) by Toronto-based Tacita Capital Inc. , investors who are concerned with risk-adjusted returns require meaningful global equities exposure.

The annualized return of the MSCI world index from January 1970 through January 2010 was 9.4%, virtually identical to the 9.5% return of the S&P/TSX composite index. However, the volatility of global equities was materially lower. The annualized standard deviation of the MSCI world index was 15.2%, much less than the 18.4% of S&P/TSX composite index. This means global equities gave inves-tors a less bumpy ride.

The typical drawdown (i.e., peak-to-trough loss) in global equities was much less severe. The average drawdown of the MSCI world index was 5.9%, materially lower than the 10% average drawdown of the S&P composite index. Thus, on the reward-to-downside risk metric measured by the Sortino ratio, global equities were the clear winner.

When Canadian stocks outperformed, it was the result of the fortunes of the materials and energy sectors. Similar to the most recent decade, Canadian stocks outperformed global equities during the commodities boom of the 1970s. However, during the 1980s and 1990s, global equities surpassed Canadian stocks by an immense margin: the annualized return of the MSCI world index of 17.1% was far ahead of the 11.4%

return of the S&P/TSX composite index. The boom/bust nature of commodities adds an element of cyclicality to the Canadian market.

Most important, a broadly diversified portfolio of 50% global and 50% Canadian equities earned an annualized return of 9.6% over the 40-year period, slightly ahead of each of its asset class components. With an annualized standard deviation of only 15.4%, the diversified portfolio was much less volatile than a Canadian equities portfolio. Critically, on the vital reward-to-variability metric measured by the Sharpe ratio, the broadly diversified portfolio also ranked well ahead of each of its components.

In short, a broadly diversified portfolio that incorporates both global and Canadian equities has been the best performer on a risk-adjusted basis. Canada's scanty exposure to such important sectors as technology, health care and consumer staples leaves its inves-tors inadequately diversified.

Advisors have an outstanding choice of alternatives in the global equity fund asset class. Given the plethora of share classes — including capital, T, F and, most recently, the addition of currency-hedged selections — there are more than 1,200 investment options. Interestingly, in a performance review of global equity mutual funds, a number of global funds have lengthy track records that outstrip the performance of the MSCI world index.

Mackenzie Cundill Value Fund, managed by Toronto-based Mac-kenzie Financial Corp., is a global value fund with an excellent performance record dating back to 1967. The fund uses a contrarian, value-based approach and hedges its foreign currency risk back into the C$.

Capital International-Global Equity Fund, sponsored by Capital International Asset Management (Canada) Inc. , combines global experience and extensive security analysis with a unique multiple counsellor system.

There is only one truly global equity exchange-traded fund in Canada: iShares CDN MSCI World Index Fund, offered by BlackRock Asset Management Canada Ltd., replicates, to the degree possible, the performance of the MSCI world index, net of expenses. In the U.S., there are several options, including Vanguard Total World Stock ETF, managed by U.S.-based Vanguard Group Inc.; it is both inexpensive and liquid. **IE**

Michael Nairne is president of Tacita Capital Inc. of Toronto, a private family office and investment counselling firm.