INVESTMENT PRINCIPLES

INFORMATION SHEET FOR INVESTORS

HOW TO DIVERSIFY

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IMPORTANT NOTICE

The term "financial advisor" is used here in a general and generic way to refer to any duly authorized person who works in the field of financial services, including the following:

- Investment brokers
- Mutual fund brokers
- Scholarship plan dealers
- Exempt market dealers
- Portfolio managers
- Investment fund managers
- Life insurance agents
- Financial planners (F.Pl.)

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HOW TO DIVERSIFY

There are many ways to diversify a portfolio. We diversify because we cannot easily forecast expected returns. This document focuses on the basic approach to diversification: across asset classes, styles and geography. Furthermore, we will make the argument that US investors do not need to diversify internationally as much as Canadian investors. Furthermore, US investors need to reduce their exposure to foreign currency while Canadian investors should embrace it.

DIVERSIFYING ACROSS ASSET CLASSES, STYLES, GEOGRAPHY AND ECONOMIC DEVELOPMENT

An asset class is generally defined as a broad group of securities/assets that offer similar characteristics, behave similarly in the market place and are subject to the same laws and regulations. The traditional asset classes are equity, bonds and cash equivalent. Commodities and real estate are also often characterized as asset classes.

An investment style refers to the general portfolio characteristics that are favored by the investment philosophy of the manager. Besides simply indexing (such as replicating a market index like the S&P 500), the best-known styles in equity investing are defined around firm size (small, mid, and large) and fundamental attributes (value, blend, growth and momentum). Value managers are looking to invest in securities that appear attractively priced, while growth managers are looking for firms that are likely to expand quickly. Blend is a mix of the two styles, while managers who favor momentum are trying to ride the wave of securities that have risen in price recently. Each approach has its risks and potential rewards, and their respective expected excess performance against the market in general is imperfectly correlated – a positive attribute.

Geography usually refers to countries but more often to regions, such as the Americas, Europe & Middle East and Asia, or the US and international (non US). Level of economic development refers to developed, emerging and frontier economies and markets. Diversification across geography and economic development seeks to benefit from the imperfect synchronization of economic growth, differences in valuation across financial markets and exposure to different currencies.

An efficient diversification process should minimally incorporate diversification across asset classes and geography. The following table illustrates why it is desirable to diversify across asset classes, styles and regions. The table ranks five specific asset classes as well as a balanced portfolio according to their returns by periods of two years between January 1991 and December 2014. It also presents the average compounded return (in USD) over the entire period. Each asset is color coded, which highlights the fact that no asset dominated each year.

The data for the entire period shows that riskier assets tend to be rewarded in the long run, but there were some unexpected results even considering the full horizon. Among asset classes, emerging markets and US equities dominated performance overall, but fixed income still outperformed international equity and commodities, which were dead last. The strong relative performance by fixed income can be explained by the deflationary environment of the last 15 years and the two equity market crises (2000-2001 and 2008). It is unlikely that fixed income can maintain this strong performance, since low interest rates, as of 2016, make it mathematically impossible that the level of capital gains realized in the past can be sustained. Remember that low yield to maturities are indicative of low future returns. Commodities did not do well, but they could still be considered as a diversifier within a program that rebalances the asset allocation on a regular basis. Finally, the balanced portfolio finished slightly below US equity in spite of its much lower volatility. As we would expect, it never ranks at the top nor at the bottom. Hence, a pre-packaged balanced portfolio is an appropriate approach for risk-averse investors and non-experts.

PERFORMANCE OF ASSET CLASSES IN DECLINING ORDER

TWO YEARS ENDING	1	2	3	4	5	6
Dec-92	33.5%	20.4%	12.9%	12.2%	2.9%	-9.3%
Dec-94	27.3%	19.0%	9.3%	5.2%	4.1%	-0.1%
Dec-96	29.9%	14.5%	14.3%	12.0%	9.1%	0.3%
Dec-98	29.9%	14.7%	10.9%	9.1%	-18.8%	-21.4%
Dec-00	36.2%	9.6%	7.5%	7.2%	5.9%	5.6%
Dec-02	12.2%	-2.4%	-2.7%	-4.2%	-17.2%	-17.9%
Dec-04	40.3%	30.1%	20.3%	17.4%	14.9%	4.4%
Dec-06	33.5%	21.8%	18.2%	13.0%	10.8%	3.1%
Dec-08	15.5%	-4.3%	-10.3%	-18.8%	-18.9%	-19.1%
Dec-10	46.1%	34.5%	22.2%	22.1%	17.9%	2.2%
Dec-12	8.7%	8.1%	5.9%	1.9%	1.2%	-1.5%
Dec-14	22.8%	7.1%	3.9%	1.0%	-2.0%	-19.6%
Average	9.9%	8.6%	8.3%	7.5%	7.0%	4.6%

Balanced portfolio is 20% US Equity, 20% International Equity, 10% Emerging Markets, 10% Commodities and 40% Fixed Income.

US Equity · International Equity · Emerging Market Equity · Commodities · Fixed Income · Balanced

US AND CANADIAN INVESTORS HAVE DIFFERENT DIVERSIFICATION NEEDS

US investors live in the most widely diversified economy. Its equity market balances exposure to most sectors and a wide array of potential firms in each sector. Many are global firms with substantial activities in other regions around the world. By comparison, the Canadian economy is less diversified. The financial, energy and material sectors are dominant. In relative terms, Canadian investors have a greater need for diversification in international markets than US investors.

Furthermore, the US currency is a reserve currency that tends to appreciate in bad times and depreciate in good times. The reverse is true of the Canadian dollar and of the currencies of other less diversified economies, such as Australia. For example, during the financial crisis and the 2014-2015 commodity price meltdown, the Canadian and Australian dollar significantly depreciated against the US dollar.

Let's consider a more specific example. In October 2008, large market capitalization stocks in the US and Canada declined by about 17.5% and 16.9% respectively. During the same month, the C$ declined by 12.9% against the US$, while the US$ appreciated by 14.8% against the C$.[1] Thus, a Canadian investor in the US equity market fully exposed to the US dollar would have generated a loss of only 5.3% in Canadian dollars [(1-.175)*(1+.148)-1], while a US investor in the Canadian equity market would have suffered a loss of 27.6% [(1-.169)*(1-.129)-1] in US dollars. Although both equity markets performed similarly in local currency, the performance spread measured in the respective currency of the investors was a significant 22.3%! Hence, Canadian investors have a natural hedge against global market risks, while US investors do not. In essence, Canadian investors benefit from currency risk (hedging or hedging too much is not good for them), while US investors should reduce their overall risk by hedging a significant part of their exposure to foreign currencies when investing internationally. Some investors say that hedging half the currency risk in a portfolio is a neutral compromise, but in fact, the examples of the US and Canada illustrate that hedging 50% is not a neutral decision nor is it a good decision. It all depends on the cyclicality of your home currency.

SUMMARY AND CONCLUSIONS

We diversify across asset classes, styles and regions because most investors cannot accurately forecast. Moreover, not all investors require the same type of diversification. US investors benefit from a diversified domestic equity market, while Canadian investors do not. Canadian investors need more international diversification. However, Canadian investors benefit from the fact that the US dollar tends to strengthened when the global economy is uncertain or commodity prices decline. US investors are hurt by such circumstances and would be better off buying international products that hedge the currency risk.

We did not address the issue of active investing in this document. We already mentioned that less than three managers in 10 outperform their respective benchmarks after fees over the long term. If it is a challenge for expert managers to outperform after fees, imagine the challenge of non-professional investors attempting to identify winning managers. This is an aspect to be discussed with your advisor.

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[1] It is an interesting particularity of currencies that the level of appreciation of currency X against currency Y is not equal to the level of depreciation of currency Y against currency X.