Segal Rogerscasey Canada

INVESTMENT Insight

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The Case for Global Equities

Equities remain an important component in investor portfolios. An increasing number of investors have recognized that the healthiest equity portfolios are well-diversified not only by investment style and market capitalization, but also by geography.

However, most Canadian investors still exhibit a "home-country bias": a tendency to favour investments in domestic companies and securities. In this *Investment Insight*, Segal Rogerscasey Canada explains why that bias creates a long-term disadvantage in an investment portfolio and makes the case that global equities are a way to avoid that disadvantage.

The Problem with a Home-Country Bias

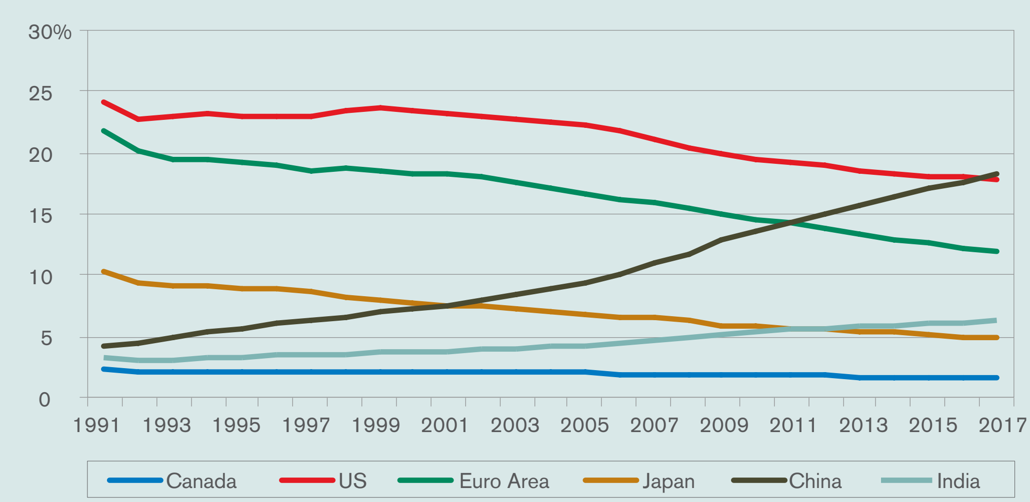
Segal Rogerscasey Canada believes that maintaining a home-country bias can limit the equity opportunity set available to investors. The primary reasons are noted below:

- ***Economic data shows that Canada has become less relevant in the global economy.*** Over the past 30 years, the Canadian share of global gross domestic product (GDP) declined on a purchasing-power-parity (PPP) basis[1] from 2.4 percent to 1.7 percent. (See Graph 1.) Developed economies, such as Canada, will grow at a slower pace than developing economies that have higher potential for growth in capital stock and productivity and more favourable demographics. For example, the IMF projects that Canada's GDP will grow at an annualized pace of 2.2 percent over the next five years, significantly lower than the 8.4 percent projection for China and the 6.5 percent projection for India.[2]

[1] GDP on a PPP basis is the total value of all goods and services produced in a country in a year, converted to a common currency using the exchange rate that would equate the cost of a basket of goods in one country with that in another country. For example, if the Canadian dollar trades at par with the U.S. dollar, but a basket of goods in Canada is more expensive than the same basket of goods in the U.S., U.S. GDP in Canadian dollars would be higher than U.S. GDP in U.S. dollars.

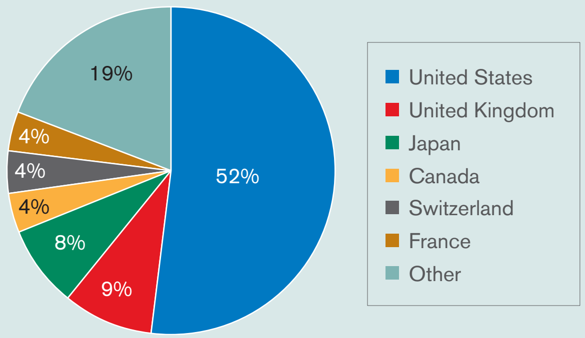
[2] International Monetary Fund. *World Economic Outlook Database*, April 2013. Retrieved from http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx (accessed July 17, 2013).

Graph 1: Share of World GDP Based on Purchasing Power Parity



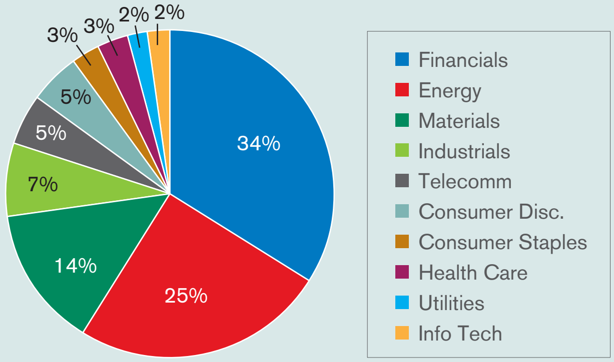
Source: http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/WEOApr2013all.xls

Graph 2: MSCI World Index Country Weights



Source: MSCI World Index: http://www.msci.com/resources/factsheets/index_fact_sheet/msci-world-index.pdf

Graph 3: S&P/TSX Composite Index Sector Weights



Source: http://us.spindices.com/indices/equity/sp-tsx-composite-index

- ***Canadian companies play a very small role in the MSCI World Index relative to non-Canadian companies.*** Canadian companies currently represent only 4.3 percent of the MSCI World Index by market capitalization. (See Graph 2.) Because the MSCI World Index is comprised of companies from only 23 developed countries, this highlights the breadth of the global investment universe and the potential opportunity costs incurred by Canadian investors that pursue domestic-only investment strategies.

- ***The S&P/TSX Composite Index is heavily concentrated in a relatively small number of sectors.*** Even though Canada is a resource-rich country, it is not well-diversified by industry, where only a few companies often dominate each sector. (See Graph 3.) As of April 2013, the Financials, Energy, and Materials sectors constituted 73 percent of the TSX by market cap. Investors who invest only in the Canadian market may easily overlook financially or operationally superior international companies in sectors with smaller weights in the index.

- ***Canadian equities are unlikely to consistently outperform foreign equities.*** In the five years that ended June 30, 2013, the annualized return on the S&P/TSX Composite Index was less than that of the Canadian dollar return on the S&P 500® Index and the MSCI EAFE Index. (See the table below.) The Canadian equity market was also significantly more volatile over this period, with the standard deviation of returns on the S&P/TSX Composite Index exceeding that of these two indices. The diversification benefits gained by adding global equities to a Canadian-only portfolio will dampen the portfolio's risk exposures and produce more stable returns in the long run, independent of the performance of the Canadian market.

Performance of Selected Equity Indices for the Five Years that Ended June 30, 2013

	Return	Standard Deviation*
S&P/TSX Composite Index	–0.53%	16.57%
S&P 500® Index (CAD)	7.85%	12.23%
MSCI EAFE Index (CAD)	0.63%	15.32%

* Standard deviation is a measure of the distribution of results around the average (mean). In a normal distribution, one standard deviation above and below the mean includes about 67 percent of all samples.

Source: Investment Metrics

Advantages of Adding Global Equities to a Domestic Portfolio

Adding global equities to a domestic-only portfolio generates a higher return at each level of risk. The efficient frontier, which graphically represents the combinations of assets that produce the highest expected return at each level of risk (*i.e.*, portfolio standard deviation), shifts upward when an investor adds foreign assets to a domestic-only portfolio. As shown in Graph 4, a portfolio consisting of only Canadian stocks and bonds (the red line in the graph) will produce an inferior return at a given level of risk than will a portfolio which also contains stock from the United States, Europe, Australia and Southeast Asia (blue line in the graph).

"Adding global equities to a domestic-only portfolio generates a higher return at each level of risk."

Segal Rogerscasey Canada believes that country of incorporation is less relevant for global large-cap companies with business operations that span multiple product lines and geographies than for smaller domestically oriented companies. Restricting investment managers to invest only in stocks of companies headquartered in Canada can limit the investment opportunity set. A global developed[3] equity strategy provides the opportunity for investors to benefit from the breadth those markets offer. Consequently, Segal Rogerscasey Canada encourages all investors to review their equity structure to determine whether executing a global equity strategy would be appropriate.

Structuring a Global Equity Portfolio

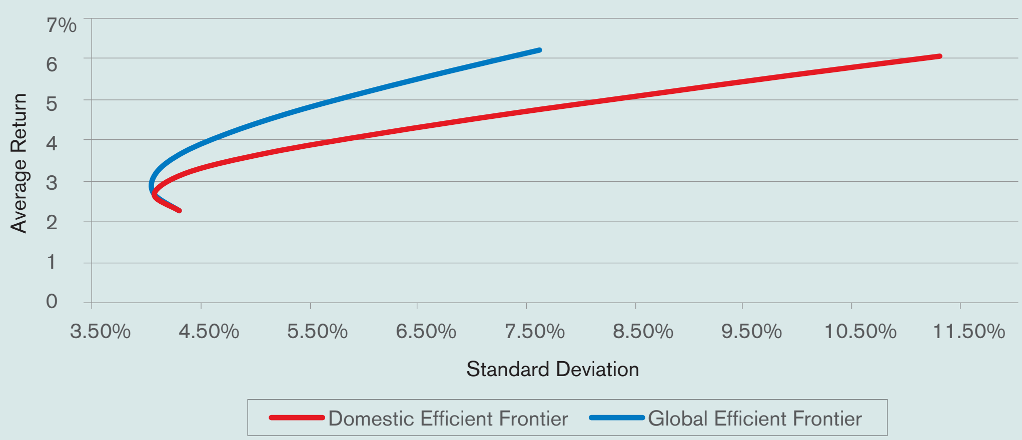
When structuring a global equity portfolio, investors should take into account the following important considerations:

- ***Relationships with Current Equity Managers*** For investors with distinct Canadian equity and international equity managers, Segal Rogerscasey Canada recommends considering the addition of global equity managers. However, it is not necessary to dismiss the legacy equity managers, as firing managers can often result in unnecessary transaction costs, especially when longstanding relationships with talented managers exist.

- ***Certain Equities Deserve Special Attention*** Adopting a global equity perspective should not preclude specialization within parts of the equity market that deserve discrete allocations. Specifically, investors should consider investing or continuing to invest with specialized emerging markets equity and small/mid cap equity managers. Emerging markets, which are relatively

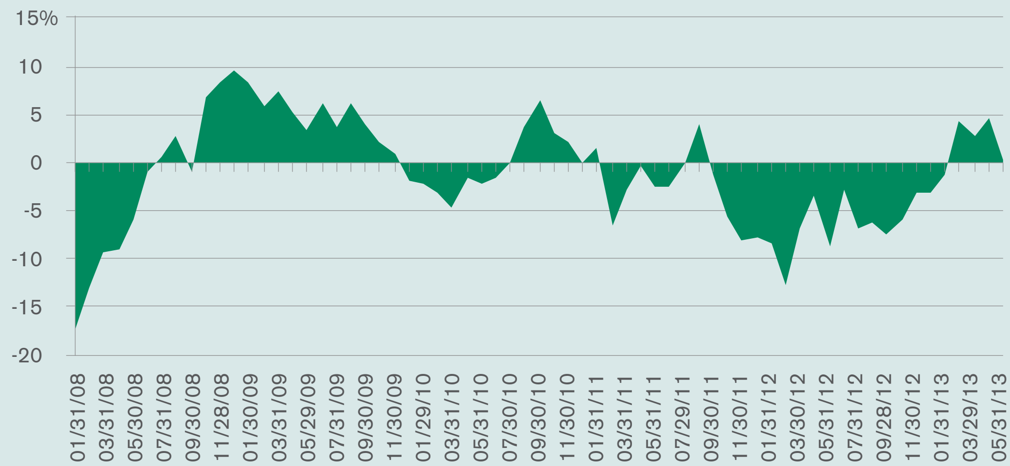
[3] "Developed" refers to non-emerging economies.

Graph 4: Domestic vs. Global Efficient Frontier



Source: S&P Dow Jones Indices LLC: http://us.spindices.com/indices/equity/sp-tsx-composite-index

Graph 5: Currency Impact – MSCI EAFE Index CAD vs. Local



Source: Bloomberg L.P. "Currency impact graph for MSCI EAFE Index CAD vs. Local." Retrieved June 11, 2013 from Bloomberg database.

"inefficient," offer specialized managers more opportunity to generate alpha[4] by using unique skills and insights to capitalize on security mispricings and relative values. Managers that specialize in emerging markets have superior local knowledge that makes them best positioned to manage their inherent risks. Segal Rogerscasey Canada also suggests relaxing investment constraints to allow small-cap managers to invest in more mid-cap names ("SMid"-cap strategies)[5] as part of their investment guidelines.

"For Canadian investors, shifting to an equity structure that includes more overseas exposure will lead to an increased exposure to currency risk, which can be significant."

- ***Currency Risk*** For Canadian investors, shifting to an equity structure that includes more overseas exposure will lead to an increased exposure to currency risk, which can be significant, especially in a low absolute return environment. For example, on a rolling three-year annualized basis, the currency impact on the MSCI EAFE Index has ranged from -17.4 percent to 9.5 percent. (See Graph 5.) An active currency overlay manager can help to manage this risk, particularly when non-Canadian currency exposure approaches or exceeds 20 percent of the portfolio.

Conclusion

Segal Rogerscasey Canada is aware that each investor has unique preferences and requirements that may have an impact on their ability or desire to move toward a more global investment structure. Canadian investors in large-cap equities should consider shifting their portfolios to a truly global equity structure by adopting a distinct global equity mandate. ■

[4] Alpha" is a measure of performance comparing the risk-adjusted returns of a manager above a stated benchmark.

[5] U.S. SMid strategies refer to those investment products that can invest in both small- and mid-capitalization companies.

Questions? Contact Us.

To discuss global equities and how they might be used in your investment portfolio, contact your Segal Rogerscasey Canada investment consultant.

Segal Rogerscasey Canada

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