Why Global Diversification is Good for Canadian Investors

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada. Marcelo, how are you today?

Marcelo: Keith, I'm doing great. It's been a great summer. I love the renovations we did in the office. The team looks great. It's a great subject we have today. It's going to be good.

Keith: I'm happy to be back. The last two episodes were yourself and Lawrence, and then yourself, Lawrence, and Jackson, which was great to see the full breadth of advisors stepping up and contributing to the podcast. So super thrilled that happened, but super happy to be back.

Marcelo: I can't believe we're at episode 84. It's been a good journey.

Keith: One of the stats that I saw last week was that only 20 percent of podcasts make it past the first year. And I remember sharing that with you, but I'm super proud of the fact that we as a team, as a firm, as a group have been able to keep the podcast both in English and French for three and a half years now. Which is a great accomplishment. So, thanks to the listeners for their feedback, for encouraging us with more topics, but it's been a really good experience.

Marcelo: It truly is a marathon.

Keith: It is. It is. But you think about how much we learn as advisors. So let's jump into today's topic. We're going to be talking about international diversification from a Canadian investor perspective. And so, there's a lot to unwrap here. We've actually created two episodes. So, today's episode will be part one, and we're going to review why Canadians should diversify globally. So, the number one question, why? We're then going to look into what does the data show. Are they diversifying? What are we doing here as Canadian investors? We'll compare that to what our international investors are doing, investors from around the world. And then finally, we're going to refer back to a Vanguard report, one that has just recently come out, speaking about what is the ideal equity allocation for Canadian investors.

Marcelo: It's a great report.

Keith: So that's going to cover off this first part. So let's jump into it, Marcelo. First of all, it's the big question and we don't want to get too hung up on why diversify, but let's talk about that a little bit. Diversification is often used in the investment industry. Many investors aren't a hundred percent sure what it means and how it works. Let's spend a few moments talking about that. So, Marcelo, why should Canadian investors diversify? So, let's go into the context of how diversification came about and then evolve the conversation.

Marcelo: Diversification is a fundamental concept in modern finance, but it hasn't been around forever. Back in the day, people used to do 5, 10, 15 stocks until Henry Markowitz came up with the concept of modern portfolio theory, which pretty much said that he realized that you could own a portfolio that's diversified across sectors, geographic allocations, and many more stocks. And you can achieve similar returns with lower risk. So, this was a breakthrough in the industry. He won the Nobel prize for it. And it became like the golden standard for how portfolios should be built. Now, does everybody do it? No.

Keith: And a lot of the research talks about higher returns for lower risk as defined by volatility, which is this movement of how far portfolios go up and down. And the real breakthrough that came through in that concept of diversification is you want to mix non-correlated assets. So, you want to mix assets that don't move together. In other words, they don't go up and down. They're not related a hundred percent. They're not correlated at one. You want to find asset classes that are not identical in their movement, but when you add them together in a portfolio, you create a smoother ride. So, it's the yin and the yang counter each other. But when you do it with six or seven asset classes, you end up with a higher return at lower risk. So, we have an example to share. And it's the starting discussion point of why diversify if you're a Canadian investor.

Marcelo: Yeah, it's a great example. And the example we have is from the year 1991 up until 2022. So, if I looked at the returns from the S&P TSX Composite Index, which is the better representation of the Canadian stock market, the annualized return was 8.44. Okay. The annual standard deviation for that period was 14.12. So, you got 8.4 and your volatility measured by standard deviation was 14.1. I think that's easy to understand. We'll look at a globally diversified portfolio that holds small cap stocks, is diversified across many markets, different sectors, and various asset classes. You would have gotten for the same period, 1991 to 2022, you would have gotten 9.4. About 1 percent more, compounded annually. The standard deviation was 11.4. Higher return, lower risk.

Keith: Yeah, we want to make sure that we're not getting too numbers oriented in a podcast, because it's hard to follow sometimes. But essentially, you just described a Canadian domestic-only portfolio versus a globally diversified same weightings in Canada. And what we saw was a 1 percent improvement over 30 years. So that's compounded. So that rate of return improved by 12%. And then your risk, the volatility, the bumps in the portfolio improved by 16%. So that sounds like a way better portfolio. So, in sort of real-person terms, what that also means can translate into, if you can generate a 1 percent

additional return over a 30- or 40-year period versus the alternative, that allows you to get to your final destination quicker with fewer bumps. And so typically it's the big bumps in the road that get people into trouble, where they make mistakes, they sell things at the wrong time. You're increasing your return. You're getting to your final destination faster. You're also thinking of it more efficiently with fewer bumps in the road. It's a better experience overall, right? So less chance to make mistakes.

Marcelo: I would even argue, like not even looking at the numbers. If you have two people that have a 10 percent return, but one portfolio had a lower volatility or lower risk. They're both happy at the end, but the one that had lower risk had a better experience overall, and that matters.

Keith: Yeah, it does matter. And then for retirees, of course, the bumpier your portfolio in a drawdown environment where you're taking money out, the faster you deplete your portfolio. So you also have to be very careful there. So that's from a numbers perspective, some justification around why you diversify globally. There's also another area that I think is so important for us to talk about, which is for investors, sometimes if you get trapped, if you get concentrated in a market, a local market that is having a really rough period, global diversification can really rescue you through that experience. So what are we talking about here? And do you have any experiences of what that might look like?

Marcelo: If you look at the U.S. market in the last, I think I would say from 2010 to 2023, it's been absolutely the best returns that you can find across markets geographically, right? Without getting into the specifics of certain stocks, but that hasn't always been the case. So, if you think about this concept of global diversification and investing in one market, if I gave you from the period of 2000 to 2010, that's what's called in the United States.

Keith: I know where you're going. You're going into the lost decade here.

Marcelo: Correct. So we're looking at the lost decade. So, if you gave me $1 Keith, January 1st of 2000 up until December 31st, 2010. So 10 years, that dollar would have turned into 72 cents. So that's a negative cumulative return of 27%. So, if I do that yearly, compounded annually, it's minus 2.9. So, you lost money over 10 years in the U.S. market. So, if I flip the coin and I say, Hey, you know what, that dollar you gave me, instead of putting it into the S&P 500, I'm going to put it into a globally diversified portfolio that holds 30 percent allocation in Canada. The rest is weighted in U.S. and international markets. It's broadly diversified, so nothing too crazy across many sectors, many asset classes. That same dollar would have given you 2.08. So that's a cumulative return of 108 percent done yearly. So compounded annually, it's 6.9. Much greater return, much better ride, and much better experience.

Keith: I lived through that period as an advisor, all the way through. But what I find fascinating about this example is, if one was to say, what's the best performing stock market in the world, all of the data shows the U.S. market over the last hundred plus years. has produced the highest consistent return for investors. But here's a perfect example of the best performing equity market in the world had a drought. The drought lasted 10 years. If you're a Canadian investor, we just showed you a U.S. drought. There are different droughts all over the world. Japan has been in droughts. You could argue anybody that has lower returns is potentially in a dry season. Canadian stocks fell into a drought between 2010, which was the high of that commodity, all the way to 2020, which people didn't want oil, gas commodities and Canadian stuff. So you do find yourself in these periods where a local market can have a drought and global diversification. It's the best way to protect, to make sure that investors can get through difficult periods in their local market.

Marcelo: I always use that example because as the U.S. market has been the best in the last 10 years and clients will go, “hey, why don't we put more instead of the allocation that we have in U.S. markets, which is roughly around a third of the equity portfolio. They'll say, why don't we just put 50 percent or 60 percent or 70 percent in the U.S. market?” And I always say, “You know what? We have to be careful with that because we can go through a period like the last decade and really tank and hurt the portfolio.”

Keith: I've been running client portfolios with the same models now for over 23 years. And so at a third Canada, U.S., international, approximately plus or minus a little bit here and there. I remember 2009. It's a period where the U.S. was collapsing, the housing market in the United States had created this global housing crisis. You had a financial meltdown on Wall Street. If you're a Canadian investor, you looked at that U.S. side of your portfolio, you've been in stocks for a decade at minus 32%. Human nature is such where you say, I don't want to invest in the United States. And of course, that's exactly what you should have been doing at that point. But the reality of it is, if you had the globally diversified portfolios throughout both these two decades, which we're speaking about, you had a smoother ride and you had really strong returns over time, you didn't have the best of any one particular asset class, but that's what diversification is all about.

Okay, so these are really two solid examples as to why this is the why behind the topic we're talking about. What are some of the more granular examples we have? Talk, Marcelo about the size of the Canadian market relative to the rest of the world and why we should be diversifying globally.

Marcelo: So, if we allocate and we give a value to, we have this measure called market capitalization, which is pretty much how many shares a company has times the price. And you get a number and that's your market cap for a single stock. So, we can measure the whole world's portfolio. We can measure every single stock in the world and say, okay, what country represents what proportion. So, if we aggregate all Canadian equities and we compare it to the world's portfolio, we are only 3.4 percent of the global stock market. So

that's a very small, tiny portion of the whole pie. So, if you take that further, it's not only 3%, but it's also concentrated among three industries, right? So, we have not only a problem that we're a small size market compared to the market overall, but we also are a highly concentrated economy in three industries.

Keith: Okay. So those are great points. What that means also is that if you're a Canadian investor and you want to be looking outside of Canada, 96, 97 percent of the world's investment opportunities are outside this country. And so I look at that and say, why would you not want to be investing and making sure you have diversification in all those other companies? Those are all three tremendous points as to why we diversify. We want to open up this segment of the podcast around why, because it helps explain the next parts.

Marcelo: Of course. And by the way, the three industries are, everybody knows, I think, but it's financials. Obviously, the big banks, energy. Resources are a big part of our economy. And then the third one is industrial. So that represents a big chunk.

Keith: Oh, and then right behind industrials is materials. There was a period before 15 years ago, materials would have been ranked higher. Okay. So we've talked about the why now let's talk about what in fact are Canadians doing? Let's look at the data and see, are Canadians taking advantage of this concept of global diversification?

Marcelo: So they are, but not as much as we'd like to see based on the theory and what we know. So, we know that the Canadian market represents about 3 percent of the global stock market. But what we know is that from the data that we have from the Vanguard portfolio, the Vanguard report is that Canadian investors allocate 52 percent of their equity allocation to Canadian markets. So, the rest, the 48 percent remaining is allocated across international and U.S. markets. So broadly speaking, if you pick a Canadian out of the population, chances are that 52 percent of his equity allocations are in Canadian stocks.

Keith: Now, this is a concept, so we're overweighting. We're buying way more Canadian stocks in our portfolios. We, I say Canadians. Then what Canada represents within the global stock market. So, we're overweighting our local market. There's a term for that. What's that called?

Marcelo: It's called the home bias.

Keith: Tell me Marcelo, what is home bias and how do we look relative to other nations, other investors around the world?

Marcelo: So, I think there's something very human being at play here, but home bias is pretty much an investor's preference to invest primarily in domestic equities rather than diversifying with foreign equities. So, in other words, it means that you feel more familiar with your surroundings, your local stock market, and you feel more enticed to invest in that country. So, it's not something foreign to Canadians. It happens all across the world. I'll walk

you through the numbers, but there are a few other things that are worth mentioning. So, for example, when you do international investing, there's transaction costs, some stocks may be inaccessible. You may be unfamiliar with some markets. So, I think it's also worth mentioning because at the end of the day, there are some things to consider on the more practical side, not only on the familiarity side. So you'll have things like currency movements to take into account. Some people may feel like they don't want to do it because they don't want to deal with the currency movement. Some people may feel like the transaction costs are too high if you're buying international equities. Other people may feel like I don't want to invest in emerging markets because I don't trust the corporate governance. So there are a few things that are at play here, but broadly speaking, think about it. You walk outside, you see RBC, you hear about Canadian oil companies constantly on the news. So naturally you'll feel more comfortable putting your money in things that you know.

Keith: So how do we rank relative to other countries, other types of investors around the world? So we're guilty of home bias. How about Americans? How about Europeans? How about other countries? What does it look like?

Marcelo: So I'll walk you through the numbers that we have. So Canada, again, 3 percent of the stock market, Canadians allocate 52 percent of their money to Canadian stocks. United States, 65 percent of the global stock market. That's what the U.S. represents. They put 80 percent of their money in the U.S. markets. I think that's understandable. Australia, which is a very similar economy to Canada, resource-based, small market compared to the U.S., they represent 2 percent of the global stock market. They put 67 percent of their money into Australian stocks.

Keith: Hang on. So the Aussies are worse than the Canadians.

Marcelo: They are.

Keith: Okay. No, my dad is Australian and he would be shocked to see this for sure.

Marcelo: And then Japan is the same thing, represents 6 percent of the global stock market. Japanese people put 64 percent of their money in Japanese stocks. And this happens, the Euro area is the same. Europe represents 18 percent of the global stock market. Europeans put 54 percent of their money in European stocks. The best one that we saw in the report is the United Kingdom, where the UK represents 4 percent of the global stock market, and they only put 26 percent into UK stocks. So those are the numbers. And it's pretty consistent across the board.

Keith: The best one are the Americans because the Americans put, it's proportional to because they have, their market has grown over the last 20 years because their companies have appreciated. Whereas everybody else's, their companies have become more expensive, appreciated. They're probably the closest, but everybody else, if you're a Canadian or Australian, European, Japanese are really skewed in the home bias, and that's

something we're going to speak about, and that's what we're suggesting has to change. Now, home bias has evolved over time. Marcelo, I recall as an advisor in the nineties, most Canadians would have RRSPs. They actually had a limit. They had a limit. And we were talking about this offline. As a Canadian, you're only allowed to invest 20 percent of your RRSP in non-Canadian companies. So we have this legacy, whether it's government constraints. Which influenced investors to ensure that Canadians bought Canadian companies. It went from 20 percent, then it was lifted to 30 percent. I remember the day it got lifted to zero. In other words, a Canadian investor could actually buy anything they wanted in the world. Now, incidentally, the timing wasn't perfect because if you were to rush to buy U.S. securities, you would have got yourself stuck in the lost decade. So, when we were speaking to Lawrence as we were getting ready for this show, he was sharing an example of guardianship, because he's working on a client file with guardianship. And the government was insisting that if you invest globally, that included U.S. securities, you are taking on too much risk.

Marcelo: They had to build a case to do it.

Keith: They had to build a case to go back and say no. We have more risk if we just stay in Canadian stock. So there's these legacy positions that kind of float around within Canada, which kind of encourage and prop people up, but for now, close to 20 years, we are free to invest anywhere we want all that to say it went from maybe 80 percent where we were concentrated in Canada to, we've got data that shows 10 years ago we were at 65% and now we're down to 52%. It has gotten better. The trend is getting better. Canadians are embracing this concept.

Marcelo: The industry also has evolved, right? You can now buy one ETF that gives you access to the whole world. Like back in the 90s, it was harder to get international stocks. When you started, you probably had to buy like a Templeton or something like that.

Keith: Yes, sir. Templeton and Fidelity. That's how you got your international exposure. And it was super expensive. Very expensive. Okay, so let's touch base on one more thing before we get into the Vanguard report. Let's talk about the concentration of Canadian companies, the 10 top companies versus 10 top companies in the world. So again, all this is going to do is highlight how concentrated our market is and how much additional risk we take when we build these concentrated portfolios. Let's talk about concentration in Canada with the top 10 Canadian companies and then concentration globally with the top 10 global countries.

Marcelo: Correct. So, if I look at the top 10 Canadian stocks by market capitalization, the largest one would be RBC at 141 billion. If I look at the top 10, that represents in Canada, 37 percent of the Canadian stock market.

Keith: Okay, so close to 40 percent of your holdings are in those top 10 companies.

Marcelo: Correct. If we look at how much those 10 Canadian stocks represent in the global market, they only represent 1.1 percent of the global stock market.

Keith: The link here is that 40 percent of your portfolio represents a really tiny portion of the global stock market opportunity set.

Marcelo: Correct. Now, if we look at the top 10 holdings in the global equity, the whole stock market in the world, the largest company would be Apple at 3.5 trillion. The top 10 represent 15.16 percent of the whole global market. So a much lower proportion. So, when you're in a globally diversified stock market portfolio, your risk is way lower because you're all spread out.

Keith: So, what this implies is that the home bias effect starts to lead Canadian investors into concentrated industry, concentrated company, and we're missing out on some of the benefits that come with global diversification.

Marcelo: By the way, when I was graduating university in 2014, I remember the big conversation was which company was going to be the first one to get to 1 trillion. And the fact that Apple's now 3.5 trillion, it's just crazy. If that doesn't convince you to invest in the stock market, I don't know what will.

Keith: So, you guys did your show on the psychology of money and I'm reading it right now, which is an incredible book. And they talk about how everything is skewed to the far right. And when you think you've got success, you really have to realize that a lot of that sometimes isn't necessarily luck it's by chance, it's timing. And they're talking about the other day for Apple, all the money, all the profits are coming from one product, the iPhone. Amazon, all of the profits don't come from selling books, they come from AWS. There was AWS and there's one other subdivision inside of Amazon. And so, it was talking about really the luck of how these products and services evolve over time. And you don't know 10 years in advance what's going to pop up, hence diversify.

So, we're going to wrap the show up with the Vanguard report now. So now we've talked about why diversify. We've talked about, are Canadians diversifying? And we're finding that they are, but nowhere near enough. Now let's switch gears and talk about the Vanguard report. So, Vanguard is one of the largest investment management firms with a real heavy tilt slant towards indexing, heavy on academic research, heavy on asset class research. And they came up with a wonderful report on the case for global diversification for Canadians. So, give us a highlight, the big picture and what do they compare, the two different portfolios and what's their final recommendation?

Marcelo: By the way, most of the numbers that we've covered in the report about home bias come from that report. So, what they've realized is that the valuable starting point for building a portfolio is the market weight portfolio. So that would look like we were discussing.

Keith: That would be the world portfolio. Canada represents 3%, U.S. is heavily represented.

Marcelo: So that would be the optimal portfolio. Then you have the market, the portfolio that Canadians are choosing, which is the 52 percent in Canadian stocks, 48 in international and U.S.

Keith: And in their report, they call that the investor preference. What are Canadians preferring?

Marcelo: What they recommend, which I like that they did this because most reports are very ambiguous and sometimes, they don't make a final recommendation. They said that the optimal asset allocation for a Canadian is to hold 30 percent in Canadian stocks and 70 percent across international markets. They don't make a distinction between U.S. And international, we have a preference internally here at Tulett Matthews, but they said 30 percent with conviction is what investors should aim for.

Keith: They would have run portfolios, and they would have had probably reasonable allocations towards U.S. cap-weighted and international. But what they did was they ran their portfolio, through 60-40, 60 equity, 40 fixed income, as well as 100 percent equity. And for this entire episode, Marcelo, we're not talking about bonds. We're talking about diversifying within equity, but they found that with both of those examples, the optimal is 30 percent Canadian stocks. So, Canadians have to still wean themselves from Canadian stocks. They have to reduce; they have to reduce from 52 down to 30 percent. “Have to”, that's the recommendation, but that's what that would mean going from 52 to 30.

Marcelo: So it's what we're seeing, right? Like it was way higher way before it's trending downward. People are diversifying more, but we're not there yet.

Keith: What I find fascinating about the Vanguard report is that they came up with a report which essentially supported what we have been doing at our firm here for over 25 years. And it's almost bang on, and obviously it was an interesting report for us to see because it's nice to see that. And part of it is because they felt it was reasonable. Part of it is because when they ran the numbers, it worked, and it creates an optimal return and risk scenario. So, we're super thrilled.

Marcelo: Nice confirmation. It's a huge group, right?

Keith: Yeah. But it is part of this podcast we're doing, which essentially is talking about why we need to build globally diversified portfolios, why all Canadians should be building portfolios that way. Talking about what are we doing? And then the Vanguard report caps it up quite nicely in terms of what we should be doing. So, Marcelo, let's talk about takeaways here.

Marcelo: So, my takeaway, to me, diversification, it's like a well-balanced diet. I would love to eat steak every day, right? Then we may think that we want just one market, but the reality is that you can't have that. You need a balance. You need a well-crafted diet. You need some beans, you need some greens, you need some fiber, you need a bunch of stuff to have an optimal diet. And I think when it comes to a portfolio, it's the same thing. You want a little bit of everything. It's going to suck sometimes, right? Because you're going to be in markets that are not doing so well, but that's the whole point of diversification. I can't remember who said the quote, but they said the whole point of diversification is that you're going to love some stuff in your portfolio and you're going to hate some stuff. And if you don't have that, you're not properly diversified.

Keith: Oh, well put. I like that. So, the only thing I would add to that is that today it's easier than ever before to get exposure as a Canadian into the U.S. market, into the European and EFI market, and to the emerging market. So, 20 years ago to get outside of Canada, let's say to get outside of Canada, the United States, you'd have to buy a 2.5 percent MER mutual fund. With exchange-traded funds and a lot of the strategies we use, it's 22 to 25 basis points for globally diversified portfolios. In the United States, you can get exposure at three basis points, at five basis points. And so, there's no excuse now. And a lot of these strategies can be domiciled in Canada, meaning they trade on the TSX. So, you don't have to worry about any kind of crazy foreign tax exposure. So, it's an incredible thing. I would encourage all investors to start building more globally diversified portfolios. It will create a better journey.

Marcelo: It's all about the experience at the end of the day. And it's practical.

Keith: It's better returns and you will probably have lower errors. So, thank you so much, Marcelo. This has been a great part one. Next week, we're going to do part two. We've got another great report we want to share with our listeners around international diversification, but on behalf of our team, our advisors, thank you so much to all our listeners for tuning in.

Marcelo: Thank you.

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