Thursday June 4, 2015

Home Sweet Home

With the Canadian capital market under siege again, we decided to brush off our 2006 essay, *"Who is Afraid of the Canadian Stock Market",* and update it to address the current publicity. We find it interesting that Canadian investors are willing to consider severe criticism – that our market is sub-par and exposure to it should be minimized for our best interests – with very little backlash.

> **Myth**: Canada is too cyclical and concentrated in Resources and Financials which leads to a higher-risk profile, and weaker returns. Rational investors should limit exposure in their portfolios.
>
> **Fact**: Canada's long-term market returns and standard deviation are in-line with other developed markets. Canada is modestly more weighted in its top three sectors than other major markets.

The following chart illustrates that, over the long term, developed market returns and their associated standard deviation are not materially different from each other.

CHART 1

Summary Statistics of Annual Returns % (1970-2012)

Series	Geometric Mean	Arithmetic Mean	Standard Deviation
Canada	10.1	12.3	21.9
Europe	10.3	12.6	22.1
Pacific	9.5	13.3	30.7
EAFE*	9.7	12.1	22.6
World	9.4	11.0	18.2
United States	9.9	11.4	17.6

Note: Underlying data expressed in U.S. dollars
*Europe, Australia, Far East
Source: Ibbotsford SBBI, 2013 Classic Yearbook

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Economies are such that their capital markets are structured to support their primary industries. Not surprisingly, individual countries and their economies are typically more heavily focused in industries in which they have a competitive advantage, through natural resources or technical progress, for example. This economic concentration is similarly reflected in the weighting of their stock markets.

As the following chart shows, the top three sectors in many markets typically sum to between 50 and 70 percent. This data reinforces to us that most markets tend to be skewed to a few significant sectors – and that Canada is a modest, but not egregious outlier.

CHART 2

Sector Weights Across Major Markets With Top Three Sector Weights Summed

	MSCI WORLD	MSCI ACWI	MSCI CDA	MSCI CAD IMI	UK	JAPAN	USA	GERMANY	AUSTRALIA	FRANCE	MEXICO
Financials	*20.68	*21.49	*37.42	*34.66	*23.23	*18.52	*16.03	*17.67	*55.00	*17.89	*17.68
Info Tech	*13.36	*13.96	2.15	2.43	1.18	11.48	*19.76	6.93	0.48	3.36	-
Health Care	*13.32	12.18	6.10	5.54	10.12	6.86	*15.05	*15.08	5.54	11.15	0.41
Consumer Discretionary	12.93	*12.56	6.04	6.90	9.87	*22.55	13.24	*22.23	1.75	*8.07	10.49
Industrial	10.91	10.48	8.08	8.93	7.08	*19.40	9.90	11.91	6.01	*17.57	9.41
Consumer Staples	9.85	9.67	4.15	3.97	*16.74	6.92	9.42	3.82	*7.72	10.69	*27.83
Energy	7.45	7.51	*22.32	*22.35	*14.20	0.83	8.08	-	4.16	8.88	-
Materials	5.13	5.33	*10.31	*11.59	7.82	6.10	3.24	13.98	*15.13	5.80	15.55
Telecom	3.22	3.65	2.01	1.77	5.66	5.02	2.30	4.97	2.37	2.83	*18.63
Utilities	3.16	3.17	1.41	1.85	4.11	2.32	2.99	3.42	1.83	3.75	-
Top 3 Sector Weights	47.36	48.01	70.05	68.60	54.17	60.47	50.84	54.98	77.85	43.53	64.14

Source: Sionna, MSCI as at March 31, 2015

The "Market Cap Theory", as it relates to global country weights, is a derivative and expansion of Sharpe's 1964 capital asset pricing model (CAPM). Proponents of the theory suggest that the ideal geographic weighting in an investor's portfolio should reflect the world market investable universe. In other words, assign a weight for each country according to its market weight in the MSCI All World Index. Globally, it suggests that no investor should have more than 8% of their investments in their home market with the notable exception of U.S. investors who may hold more than half their holdings at home.

Supporters of the Market Cap Theory infer that Canada's idiosyncratic market is riskier and that a well-diversified, global portfolio is a better solution. Students of economics know that, through the laws of supply and demand, economic equilibrium's gravitational pull and market forces will: (a) force a low-returning market into a normal-returning market; and (b) a high-risk market into a normal-risk market through the price mechanism. Chart 1 above shows that over the long run, the Canadian market has a similar return and risk profile to other developed markets. Throughout history we have seen economies, industrial sectors, individual stocks and novel investment fads pull ahead in terms of returns in short- and medium-time horizons, only to eventually fall back and offer normal profits and returns as economic gravity inevitably takes hold. In fact, a wise investor could take advantage of this process and buy at maximum points of pessimism and sell at maximum points of optimism, to enjoy extraordinary returns in the short and mid run.

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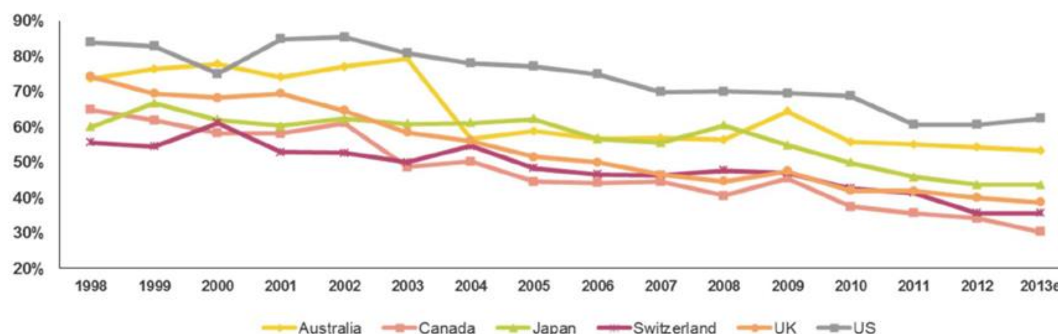
Myth: Canadians have too much of a “home-country” bias.

Fact: Investors in all Markets have a “home-country” bias for good reasons.

Research going back to 1998 illustrates that developed markets have embraced greater non-domestic exposures as indicated by pension domestic equity allocations drifting down. Chart 3 below shows that Canada’s home-country bias is actually the least dramatic of those included in the study. We believe that there are numerous benefits supporting a rational home-country bias.

CHART 3

Pension Domestic Equity Allocation over Total Equity Allocation



Source: Tower Watson, Global Pension Assets Study, January 2014

As inferred above, the Market Cap Theory ultimately postulates that all investors should buy the World Index. Additionally, by definition it assumes all markets are efficient and priced accordingly at all times. In the real world, however, market cap weights will be impacted by market valuation enthusiasm and pessimism, as well as by unpredictable currency moves. A wise active manager will act to take advantage of the inconsistencies in this theory.

National interests and the global desire for vibrant capital markets require thriving domestic capital markets. Are investors willing to pour savings earned by their home market labours into the coffers of global markets (largely the U.S.)? Financial services today represent 35% of the Canadian stock market capitalization and 6.7% of GDP. If we passively supported its shrinkage due to an untested theory, what long-term consequences might it have on our economic growth? Would Canadian entrepreneurs largely have to appeal to U.S. or global capital markets to win equity or debt funding to grow?

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Advantages to a Home-Country Bias

We believe it is rational to maintain a healthy home-country bias in response to a number of factors:

1. The natural asset/liability matching that occurs in a home market: Canadian institutions are seeking to match liabilities that are largely Canadian and individual investors are likely to be retiring in Canada.
2. No concern about currency risk or costly currency hedges.
3. Preferred tax treatment for domestic dividends, no foreign withholding taxes.
4. Lower transaction and custodian fees for domestic assets.

What Should an Ideal Home-Country Allocation Be?

The simplicity and elegance that the Market Cap Theory of allocation proposes as “rule of thumb” has likely led to its rapid acceptance by frustrated investors looking for a practical tool. Sadly, I do not believe an elegant, one-size-fits-all solution exists – and I have been searching for it my whole career!

The truth is often nuanced, complex and heavily dependent on both current unfolding opportunities and a murky, unpredictable future. The messy answer lies in understanding the individual investor’s risk appetite, hunger for return, time horizon, liability-matching (weighted domestically or elsewhere), scale and investor sophistication. All this really suggests the best answer is a different asset mix for all.

If pressed myself for a one-size-fits-all answer, it would reflect a home-country bias weighted between 40-60%, where the allocation at any point in time would depend on current conditions. For example, from a contrarian’s perspective, the domestic equity allocation should tilt to the high end of the range (60%) when the local currency is cheap relative to history, and local sentiment is pessimistic. (Caveat: as a primarily domestic equity manager I suspect I must have a bias I cannot fully exercise).

Conclusion

We do not dispute the benefits of Global diversification. When diversification is correctly executed it can contribute to better risk-adjusted returns for investors. We also believe however, that maintaining a home-country bias makes sense for many investors. Many developed nations with stable government policies and regimes, and good corporate governance can clearly justify intelligent home-country allocations well above their weights in a global benchmark. Healthy, domestic core weights, global rebalancing based on underpriced market opportunities, and remaining mindful of extreme currency positions can enhance long-term expected returns.

Kim Shannon and the Sionna Team

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