Spotlight on Geographic Diversification

When it comes to investing, Canadians have a tendency to stay close to home. Despite the relative outperformace of the Canadian stock market over the past decade, there are compelling reasons for investors to shed some of their home-country bias in favour of a more global perspective. In this issue of our Spotlight Series, we highlight the two primary and complementary reasons underpinning geographic diversification: broadening the growth potential of your portfolio and reducing overall risk.

Although it's the world's second largest country by land mass, Canada's geography dwarfs its representation in the global equity markets. With less than 5% of the global equity market as represented by the MSCI World Index, expanding the geographic reach of a portfolio allows Canadian investors to capitalize on a wider set of opportunities across various economies, industries and currencies.

Opportunity Knocks

Canada's position as a resource-based producer to the world makes our financial markets and currency vulnerable to international demand. In other words, when the U.S., and more increasingly China and other parts of Asia sneeze, Canada can catch a cold.

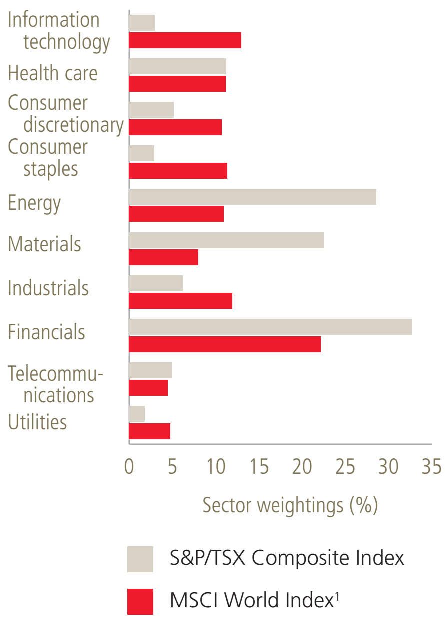
Dominated by just a few economic sectors, the prospects of the Canadian market are highly dependant on the performance of Financials, Energy and Basic Materials stocks. And while that sometimes works in investors' favour, it means having less varied exposure to the growth potential of companies in dynamic sectors such as Information Technology, Consumer Discretionary and Health Care. (See Figure 1)

Investors can also tap into the tremendous growth potential of emerging economies such as Brazil, Russia, India and China – the so-called BRIC countries – albeit at more risk than comparable developed market exposure. To read more on the emerging markets, refer to Spotlight on Emerging Markets, available on www.scotiafunds.com

Research demonstrates that no single country or regional market has consistently outperformed over the long run and that there is no failsafe strategy to determine which market will outperform in any given year. Diversified exposure to a broad array of countries and regions eliminates the guesswork of deciding when and where to invest.

Figure 1

Global Investing Enhances Sector Diversification



1 As at June 30, 2010
Source: Morningstar

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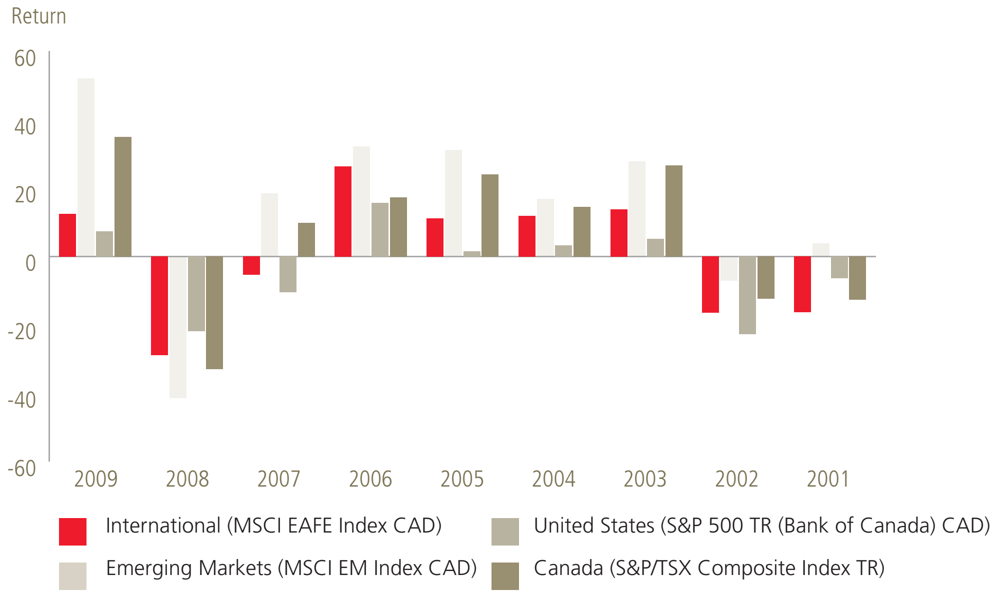
Figure 2 highlights the calendar year returns of Canadian and a variety of foreign markets. In step with the run up in commodity prices, the strength of the loonie versus the greenback in recent years has muted the total return of U.S. dollar denominated investments when converted back to Canadian dollars. While it's impossible to say when the Canadian dollar will loose steam, its inevitable turn will benefit those investors with more diversified currency exposure.

Figure 2

Calendar Year Returns Of Major Equity Market Indices



Source: Morningstar

Technically Speaking

In statistical terms, correlation measures the relationship between two investments. A correlation of one means that the two investments move in perfect unison with each other; a correlation of zero means the relationship between the two is completely random; and a negative correlation, means that they move in opposite directions.

Risk Reduction

Perhaps the most compelling benefit of geographic diversification is its historical tendency to reduce the overall risk of a portfolio. That's because the performance of foreign markets are less correlated with domestic market returns.

While negative correlations are less common in the investing world, having exposure to investments that are less positively correlated to one another means that poor performance in one can be balanced by better performance in another, resulting in less risk overall.

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Global Investing Reconsidered

The merits of geographic diversification came under fire in the wake of the 2008 financial crisis, as equity market indices spiralled lower in lockstep with one another. Investors who were exposed to global and international markets weren't necessarily harmed by their expanded geographical reach, but they weren't helped by it either.

So where does that leave us? Does investing overseas still offer a valid passport to risk reduction or does the recent convergence of market performance have longer-term implications for investors' long standing diversification toolkit?

We looked at historical correlation data between Canadian, U.S. and international equity markets and found that the merits of geographic diversification remain intact.

To be sure, these benefits are not constant over time. Correlations between developed markets in particular have risen over the years, and there are short periods on record where correlations have risen sharply, typically during periods of extreme market or economic instability. It's this same variability in the relationships between different country and regional markets, asset classes and management styles that makes their regular analysis a mainstay of professional portfolio management.

On a more encouraging note, correlations between domestic and foreign markets have historically fallen to pre-crisis levels – where the diversification benefits are that much greater. Figure 3 highlights the sharp spike and subsequent drop-off in correlations between domestic and foreign markets following the October 1987 stock market crash.

Figure 3*

October 1987 Stock Market Crash – Canada vs. Foreign Markets

	U.S.	International
Pre-crisis:		
Aug 1987	0.54	0.10
During:		
Oct 1987	0.91	0.60
Post-crisis:		
Nov 1988	0.47	0.27

* Source: Ibbotson Associates. Based on the twelve-month rolling correlations between Canadian equity market, as represented by the S&P/TSX Composite Index TR, and each of the U.S. equity markets, as represented by the S&P 500 Index TR, and international equity markets, as represented by the MSCI EAFE Index GR (CAD).

Important Considerations

Investors are encouraged to speak to their advisor about the additional risks associated with investing in foreign markets. (A mutual fund's simplified prospectus handily summarizes these risks for investors.) Among them is exposure to foreign currencies. While not the subject of this article, it's important to recognize that currency risk can impact investment performance both positively and negatively, particularly over short timeframes. Over the long term however, currency risk is generally minimized and portfolio managers may choose to mitigate short-term fluctuations in foreign exchange rates through currency hedging strategies.

The Final Verdict

Most long-term investors in Canada should maintain some exposure to foreign investments given their ability to broaden the growth potential and to reduce overall risk of a portfolio. The right amount and approach to investing outside Canada depends on the individual. Managed by some of the world's leading investment advisors, *ScotiaFunds*™ offer investors a passport to U.S., global and international markets through a large selection of mutual funds and portfolio solutions that invest in one or more developed and/or emerging economies.

Contact your advisor today

To find out more about global investment opportunities or visit us at **scotiafunds.com**

Appendix

Figure 2

Calendar Year Return	2009	2008	2007	2006	2005	2004	2003	2002	2001
Canada									
S&P/TSX Composite Index TR	35.1%	-33.0%	9.8%	17.3%	24.1%	14.5%	26.7%	-12.4%	-12.6%
U.S.									
S&P 500 Index TR (CAD)	7.4%	-21.2%	-10.5%	15.4%	2.3%	2.8%	5.3%	-22.9%	-6.4%
International									
MSCI EAFE Index GR (CAD)	12.5%	-28.8%	-5.3%	26.4%	11.2%	11.9%	13.8%	-16.5%	-16.3%
Emerging Markets									
MSCI Emerging Markets Index (CAD)	52.0%	-41.4%	18.5%	32.1%	31.2%	16.8%	27.8%	-7.0%	3.8%

Figure 3

Source: IBBOTSON ASSOCIATES, UNLESS OTHERWISE NOTED. Ibbotson Associates, Inc. is a registered investment advisor and wholly owned subsidiary of Morningstar, Inc. The information contained in Figure 1 is the proprietary material of Ibbotson Associates. Reproduction, transcription or other use by others in whole or in part without prior written permission of Ibbotson Associates is prohibited.

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† Canada = 4.4%; Source: MSCI All-Country World Index as at July 31, 2010. ‡ As at June 30, 2010.