Investors and professional money managers alike invest in different geographic regions for two primary, and complementary, reasons: to broaden the growth potential of their portfolios and to reduce overall risk. The following article examines the merits of each and reflects on recent events that have called them into question.

Opportunity Knocks

Dominated by just a few economic sectors, the prospects of the Canadian market are highly dependent 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. 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.

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 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.

Although it is the world’s second largest country by land mass, Canada’s geography dwarfs its representation in the global equity markets. With a little over 2% share of the world’s equity market capitalization 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.
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.

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.

Global Investing Reconsidered

The merits of geographic diversification have come under fire in the wake of last year’s market meltdown. As the crisis that brewed in the fall of 2008 reached fever pitch in March 2009, 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. 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 portfolio management.

Figure 2 looks at the twelve-month rolling correlations between the Canadian equity market and both the U.S. and international equity markets from July 1985 to July 2009. The chart illustrates the significant ebb and flow of correlations over time and the tendency of correlations to rise during periods of extreme market or economic instability. Increased synchronicity between domestic and global market performance earlier this year is a prime example of this temporary convergence.

Source: IBBOTSON ASSOCIATES (see Appendix). Based on rolling twelve-month correlations of Canadian equity market, as represented by the S&P/TSX Composite Index TR, and each of the U.S. equity market, as represented by the S&P 500 Index TR (USD), and international equity markets as represented by the MSCI EAFE Index (CAD), from July 1985 to July 2009.
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.

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<thead>
<tr>
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<th>U.S.</th>
<th>International</th>
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<tr>
<td>Pre-crisis: Aug 1987</td>
<td>0.54</td>
<td>0.10</td>
</tr>
<tr>
<td>During: Oct 1987</td>
<td>0.91</td>
<td>0.60</td>
</tr>
<tr>
<td>Post-crisis: Nov 1988</td>
<td>0.47</td>
<td>0.27</td>
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</table>

† 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.) Chief 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. Whether you’re looking for broad diversification across asset class, geography and management style in a convenient one fund solution or targeted exposure to select countries or economic regions, a Scotia® advisor can help you find the right mix to complement your needs and risk tolerance.

To learn more about ScotiaFunds speak to a Scotia® advisor or visit www.scotiafunds.com

### Appendix:

<table>
<thead>
<tr>
<th>Figure 1</th>
<th>Calendar Year Return</th>
<th>2008</th>
<th>2007</th>
<th>2006</th>
<th>2005</th>
<th>2004</th>
<th>2003</th>
<th>2002</th>
<th>2001</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>TSX Composite Index TR</td>
<td>-33.0%</td>
<td>9.8%</td>
<td>17.3%</td>
<td>24.1%</td>
<td>14.5%</td>
<td>26.7%</td>
<td>-12.4%</td>
<td>-12.6%</td>
<td>7.4%</td>
</tr>
<tr>
<td></td>
<td>U.S. S&amp;P 500 Index TR (CAD)</td>
<td>-21.9%</td>
<td>-10.5%</td>
<td>15.7%</td>
<td>1.6%</td>
<td>3.3%</td>
<td>5.2%</td>
<td>-22.7%</td>
<td>-6.4%</td>
<td>-5.5%</td>
</tr>
<tr>
<td></td>
<td>International MSCI EAFE Index GR (CAD)</td>
<td>-28.8%</td>
<td>-5.3%</td>
<td>26.4%</td>
<td>24.1%</td>
<td>11.9%</td>
<td>13.8%</td>
<td>-16.5%</td>
<td>-16.3%</td>
<td>-11.0%</td>
</tr>
<tr>
<td></td>
<td>Emerging Markets MSCI EAFE Index GR (CAD)</td>
<td>-41.4%</td>
<td>18.5%</td>
<td>32.1%</td>
<td>31.2%</td>
<td>16.8%</td>
<td>27.8%</td>
<td>-7.0%</td>
<td>3.8%</td>
<td>-28.2%</td>
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</tbody>
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