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Avoiding the pitfalls of home country bias

Diversification is the key to long-term success

Ask a Canadian investor if the markets have been volatile and chances are the answer will be a resounding “yes”, reflecting the fact that Canadian markets have been rockier than those of our neighbor to the south. The CBOE Volatility Index (VIX), a commonly used benchmark for the implied volatility of the S&P 500 index options, has averaged just shy of 25 from August 2007 until now. The current VIX reading is just under 15 though, which is 40% lower than the average.

One reason Canadians feel the effects of volatility so strongly is because their portfolios tend to be highly concentrated in Canadian investments. The S&P/TSX Composite Index went from a high of 12,878 in March to a low of 11,947 a little over a month later, a decrease of 7.2%. That's hard for any investor to stomach.

The tendency toward a home bias in constructing portfolios is not peculiar to Canadians. It is a common trait with investors around the globe. According to research from Vanguard, this bias is often conscious and intentional, with investors actively overweighting domestic holdings at the expense of foreign securities.

The good news is that Canadians have an opportunity to do something about it. According to a new poll conducted by Leger Marketing on behalf of Edward Jones, Canadian investors are currently holding 13% of their money in GICs. The survey also revealed that half of them plan to make some kind of investment this year.

These investors should use their cash advantage to diversify their portfolios and increase their foreign exposure. From a risk management perspective, it makes sense. A portfolio comprised solely of Canadian securities opens the door to significant volatility because nearly 80% of the S&P/TSX 60 is comprised of only three sectors: financials, energy, and materials. While the financials generally tend to be more stable, the energy and materials sectors are subject to high volatility. In fact, energy and materials have played a key role in the overall underperformance of the S&P/TSX this year.

Canadian investors can start by diversifying into U.S. equities, guarding against sector concentration risk and increasing their defensive positioning. This also gives them access to sectors such as consumer products and healthcare, which are otherwise under-represented in Canada.

According to Canaccord Genuity analysts, the backdrop for the U.S. markets remains positive, despite the extended rally. Not only are there fewer signs of systemic risk but also there are reduced policy valuation constraints. And, better than expected economic and corporate profit trends should allow for continued valuation expansion.

A simple way of adding U.S. equity exposure is to invest in exchange-traded funds (ETFs) that provide broad market exposure. Investors can opt for Canadian dollar hedged ETFs to guard against

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currency risks or they can invest directly in U.S. ETFs if they have U.S. cash. For hedged exposure, investors might consider either the BMO Dow Jones Industrial Average ETF (TSX: ZDJ) or the BMO U.S. Dividend ETF (TSX: ZUD). For unhedged broader market exposure, investors can look at the iShares Core S&P 500

ETF (NYSE: IVV) or SPDR S&P 500 ETF (NYSE: SPY).

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