

How going global can help Canadian investors

David Wolf | Portfolio Manager

David Tulk, CFA | Portfolio Manager

Key Takeaways

- Foreign asset exposure allows Canadians to achieve better risk-adjusted returns
- The optimal degree of foreign exposure depends on total portfolio characteristics
- Current tactical considerations suggest more foreign exposure than usual

How much home bias?

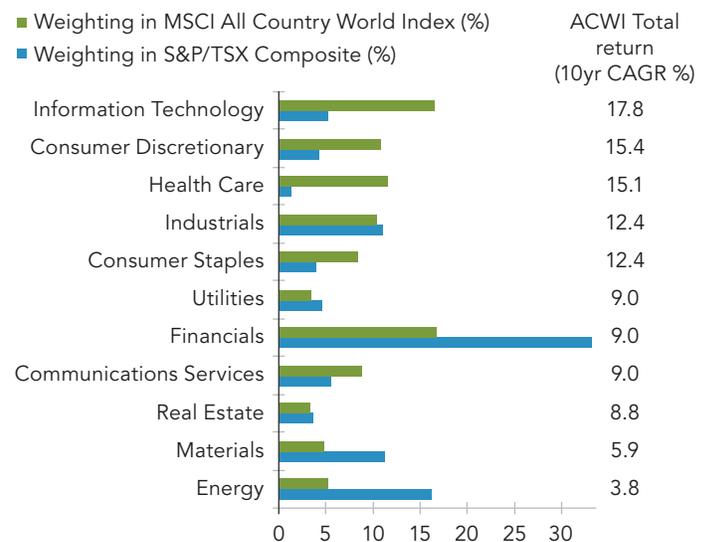
How 'home biased' should Canadian investors be? More specifically, what should the split be between foreign and domestic assets in a Canadian investor's portfolio? It's one of the most frequent questions we get from advisors, and a question we spend a lot of time looking at in our multi asset class portfolios.

The argument for holding foreign assets in a Canadian portfolio (or any home country portfolio) is fairly straightforward. Canada is only about 3% of the global market. Moreover, it's an idiosyncratic 3% – disproportionately dependent on specific Canadian sensitivities like commodity prices and the domestic consumer. This can be seen most easily in the sector composition of the Canadian equity market, which

is skewed heavily towards financials, energy and materials; there's simply not that much to buy in Canada in the technology and health care sectors that are large and growing areas of the global market (see Exhibit 1).

It is clear that investors can often realize better returns by going outside of Canada, as has been the case over the past decade. But the primary structural argument for foreign allocations is to diversify away the Canada-specific risks in the domestic market, thus managing overall risk to achieve a better-balanced portfolio.

EXHIBIT 1: Canada's skewed equity market



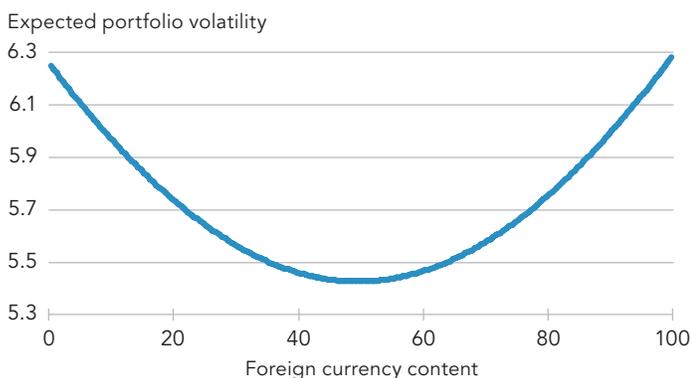
Source: Standard and Poors, MSCI, Bloomberg, Haver Analytics and FMR Co. As at October 31, 2019. Returns shown in Canadian dollars.

It depends on risk tolerance...

Of course, investing in foreign assets carries its own risks, notably currency volatility. So the 'right' degree of home bias/foreign exposure for a Canadian investor depends on his or her risk tolerance.

An investor comfortable with a larger allocation to equities should want more foreign content than an investor with a portfolio largely allocated to bonds. Both should have some foreign content, however, partly because the Canadian dollar tends to be correlated with the equity risk that dominates total risk even in a more conservative multi-asset portfolio. As a result going abroad, particularly into equities denominated in foreign currencies like the U.S. dollar, Japanese yen or Swiss franc that are negatively correlated with total equity market risk, can actually reduce a Canadian investor's total portfolio volatility. But only to a point – beyond a certain level, the currency volatility of the foreign content starts to dominate (see Exhibit 2), leading to less favourable risk-adjusted returns even for the more risk-tolerant investor.

EXHIBIT 2: Foreign exposure offers a risk 'smile'



Note: Simulation uses the Global Balanced FMP benchmark and varies the USD/CAD exposure as an overlay. Source: FMR Co.

So it really is different (foreign) strokes for different folks, but (unfortunately) not in a linear, obvious way.

...But also many other factors

The 'optimal' foreign asset allocation in a Canadian portfolio also depends on a number of other factors.

It depends, not surprisingly given the currency discussion above, on the availability and cost of foreign exchange hedging. In practice, we can hedge in our funds but tend to do so sparingly, reflecting the considerations above.

It also depends on the opportunity set of foreign assets classes and its granularity – the right total foreign exposure for a Canadian investor's portfolio is different if one can only buy U.S. stocks versus if one can invest, as we can, in a wider range of asset classes around the world.

It further depends on the liabilities that one is investing to fulfill – a Canadian investor with largely U.S. dollar liabilities will want to be thinking more like a U.S. investor, with non-Canadian exposure to match (one of the reasons we offer popular funds like U.S. Monthly Income and American Balanced).

And the right foreign allocation depends on how much future returns and correlations can be expected to look like those in the past. We blend a robust optimization based on the historical data with the secular projections embedded in our capital markets assumption process.

A set of different answers

Putting it all together, it should be clear that there's no one 'right' answer for how much a Canadian's portfolio should be in foreign assets, but rather a set of different answers that fit different settings for the variables above.

Let us offer an example. Take a Canadian investor with a risk classification in the low to medium or medium bucket invested in a 60/40 portfolio with access to the full suite of foreign asset classes on an unhedged basis. Our research suggests that the 'optimal' range of foreign exposure for this configuration, the one that maximizes expected risk-adjusted returns over the

long term, is roughly in the range of 60–80%. So some home-country bias is warranted, but not much.

It is not coincidental that the foreign exposures in our core fund-of-fund products like the Fidelity Managed Portfolios (FMP’s) generally fall within the above range (see Exhibit 3) in their Global versions. It should also be noted that the more Canadian-oriented versions of the FMP’s have higher domestic allocations for those investors uncomfortable with taking on the added risk of a higher foreign allocation, even if that allocation may be disproportionately rewarded with added return.

Note we’re looking at the ‘optimal’ allocation for the portfolio as a whole, not just the equity portion; even an unhedged allocation to foreign fixed income tends to improve the risk/return properties of a multi asset portfolio. It’s not just in equities where one wants to go abroad.

All of the above is part of how we think about ‘structural’ allocations in the Canadian multi asset class funds, contributing to the determination of a fund’s neutral asset mix and associated benchmarks. The neutral asset mix forms the foundation of the fund, specifying the asset allocation before we apply any tactical views.

Tactical views further inform allocations

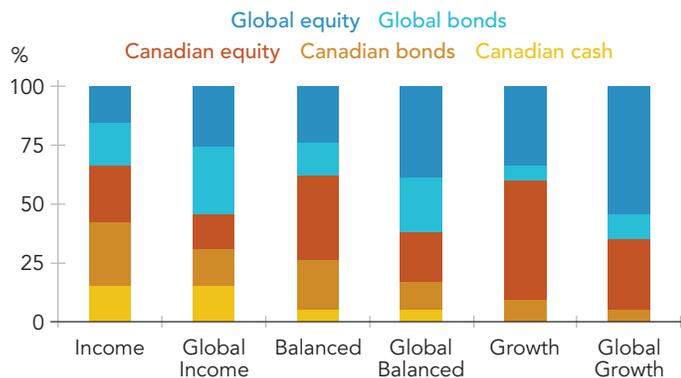
But of course we do utilize tactical views based on our research and market outlook that lead us to actively overweight or underweight asset classes relative to the neutral mix. Included in that is the foreign vs domestic split, which is shaped by our views on the relative prospects for Canadian assets against the rest of the world.

As we’ve argued previously, Canadian households remain badly overextended and could become even more so if the recent decline in bond yields motivates a further increase in debt. At the same time, productive business investment has plunged, and weaker global growth is likely to take a disproportionate toll on Canada’s small, open, commodity-producing economy. As a result, we see a relatively unfavourable balance of risk and return in the outlook for Canadian assets over a tactical horizon, and are accordingly underweight compared to a given fund’s neutral mix. A Canadian investor should generally want some foreign exposure; we think even more foreign exposure than usual is warranted at present, and are positioning the Fidelity Canadian multi asset class funds accordingly.

David Wolf and David Tulk, November 20, 2019

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EXHIBIT 3: Neutral Asset Mixes for the Fidelity Managed Portfolios



Source: FMR Co.

Authors

David Wolf | Portfolio Manager

David Wolf is a portfolio manager for Fidelity Investments. He is the co-manager of Fidelity Managed Portfolios, Fidelity Canadian Asset Allocation Fund, Fidelity Canadian Balanced Fund, Fidelity Monthly Income Fund, Fidelity U.S. Monthly Income Fund, Fidelity U.S. Monthly Income Currency Neutral Fund, Fidelity Global Monthly Income Fund, Fidelity Dividend Fund, Fidelity Global Dividend Fund, Fidelity Income Allocation Fund, Fidelity Balanced Managed Risk Portfolio and Fidelity Conservative Managed Risk Portfolio. He is also portfolio co-manager of Fidelity Conservative Income Private Pool, Fidelity Asset Allocation Private Pool, Fidelity Asset Allocation Currency Neutral Private Pool, Fidelity Balanced Private Pool, Fidelity Balanced Currency Neutral Private Pool, Fidelity Balanced Income Private Pool, Fidelity Balanced Income Currency Neutral Private Pool and Fidelity U.S. Growth and Income Private Pool.

David Tulk, CFA | Portfolio Manager

David Tulk is a portfolio manager for Fidelity Investments. He is the co-manager of Fidelity Balanced Managed Risk Portfolio, Fidelity Conservative Managed Risk Portfolio, Fidelity Conservative Income Fund and Fidelity Conservative Income Private Pool.



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