

AWAY FROM HOME

A Canadian perspective on global investing.

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Canada is incredibly well endowed, with natural resources that are in a structural bull market, population growth and capitalistic intentions that are arguably greater than that of Europe and Japan, and a large economic neighbour who is more of a consumer than a competitor. Given all this, are there compelling reasons to allocate to international equity markets? And, if so, what should the allocation be and where should it go?

Let's start with a question. Out of the following equity markets, which has been the best and worst performing during the 21st century so far: Asia, Canada, Europe, Japan, Latin America, the UK, or the U.S.? Interestingly, Latin America is the best performing market during the period, with Canada in last place. The worst has been the U.S. Now, a second question: what have the best and worst performing global sectors been so far this century? Not surprisingly Energy has fared the best, with Materials in second place. Technology has been the worst and Telecoms the second worst, a trend we expect to continue.

Investors should focus their global investments in places that have the best combination of future growth and attractive valuations, namely Asia and emerging markets. Within the developed markets, after decades of underinvestment, there are many structural growth areas and stocks to be found in the Energy, Materials and Industrials sectors. The cheapest assets to be found anywhere in the world are Asian currencies. These are cheap only because they are fixed, meaning that any long-term investor should have a significant amount of their assets in Asian currencies via equities and property, since history shows that eventually all fixed currencies revalue. Asia and the MSCI Emerging Markets Index still trade at a 25% valuation discount to Europe and North America. This valuation gap is expected to close, with these markets continuing to outperform for the rest of this decade.

Another question. Since 1998, what is the compound annual growth rate of dividend payments from

Credit Lyonnais Securities Asia's (CLSA) Asia ex Japan stock Universe: 4%, 14% or 24%? Most are stunned to learn that it is a staggering 24%. What percentage of CLSA's Asia ex Japan stock coverage has a 2005 dividend yield higher than both their local and U.S.

Government 10-year bond yields—0%, 30%, or 50%? The answer is 30%, which is very attractive when compared to only mid-teens in Europe and North America.

Correlation conundrum

But from a Canadian perspective, there is one major problem with this. The five-year rolling correlation shows that Asia and emerging markets now have an 80% correlation with the Canadian stock market, up from 60% ten years ago. This makes sense because oil and commodities dominate these indexes. Indeed, Japan is the only major market that still has a low correlation to Canada, at only 55%. So, whatever your fundamental view on Japan, it has a place in any Canadian portfolio purely for its diversification benefits. I believe the fundamental changes in Japan are genuine, that the 15-year bear market is over and that investors should buy the dips.

FMSCI data continues to show that, in North America and Europe, the average stock is driven more by its global sector than by the country it is in. However, the opposite is true in Asia, emerging markets and Japan. It's not enough for bottom-up fundamental research to tell one that Samsung, Petrobras and Toyota Motor Corporation are the best technology, energy and car stocks globally because their share price returns are still primarily driven by whether their local markets are going up or down. Therefore one still has to take the country effect into account, with old-fashioned, top-down research as well as detailed bottom-up research. One of the easiest ways to make money globally is to buy these and other global winners after their share price has been beaten down by local or country concerns, such as elections or corruption scandals. ■