HOW GLOBAL IS YOUR PORTFOLIO?

U.S. stocks might not provide the diversification you think.

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Ask most investors about the degree of global diversification in their portfolios, and they will usually reply with the specific percentage of their portfolios that is invested in stocks outside their home country. For most investors in North America—Canadian as well as those based in the United States—this percentage has been rising over the past decade as institutional investors have become increasingly aware of the benefits of global diversification.

The path to analyzing the benefits of global diversification is well-trodden. Using a capitalization index that does not include their home country as a candidate, investors typically evaluate the risk and return implications of shifting a portion out of their existing allocation to the candidate index. Most studies show that allocating 20-30% to a non-domestic portfolio yields significant diversification benefits. While this type of analysis clearly demonstrates the benefits in a straightforward manner, it fails to account for the fact that the degree of capital market integration varies across countries and by sectors.

A variety of institutional impediments (tax and regulatory regimes, variable governance standards) and the fact that some industry structures are still local (for example, there is little global competition in railways or utilities) prevent full integration of global capital markets. If the world were fully integrated, investors would be best served by giving their investment managers global mandates in order that they may seek out the best opportunities regardless of the country of domicile. In contrast, if returns were primarily driven by local factors, investors should hire specialist managers for each country or region, as the lack of integration makes it impossible to trade off investment opportunities across countries.

The key question, obviously, is the degree of integration between markets. One way to evaluate the degree of integration is to analyze the extent to which a local sector return can be explained by global market and sector effects. In Canada, sectors such as basic industries, resources, and financials are clearly globally integrated in that more than 50% of their returns can be explained by global market and sector returns. In the U.S., the majority of the return of every sector is explained by global factors. By contrast, in Japan and the Pacific region the majority of the return continues to be relatively independent of global sector and market factors. In Japan, only in the cyclical consumer goods sector (which includes automobiles and household goods) do global factors explain more than 50% of the return variation in the local sector return. European sectors lie somewhere between the U.S. and Japanese markets in terms of their level of integration.

From the perspective of a Canadian investor, these results suggest that the greatest diversification benefits stem from investing not in the U.S., but in Japan, the Pacific region, and Europe. Historical analysis in which the non-Canadian content was allocated to Europe, Japan, and the Pacific region confirms that the diversification benefits are indeed greater with these markets than with the U.S. From a implementation perspective, the high level of integration between Canada and the U.S. suggest that a North American mandate would allow for the best opportunity to add value from active management, as opposed to hiring separate managers for the U.S. and Canada.

Grouping markets and sectors based on their actual correlations with each other—as opposed to national boundaries—represents a logical progression in terms of identifying and allocating the risk within an investment portfolio. Diversifying where it counts, i.e., into regions or countries which are uncorrelated with their local market, results in a truly globally diversified portfolio, and enables investors to fully realize the risk reduction benefits associated with global investing. Additionally, by structuring active mandates across markets that behave in a similar fashion, investors can maximize the chance that their active managers will add value. Both these portfolio allocation strategies represent an improvement in potential portfolio efficiency—supporting the claim that diversification represents the only free lunch! ∎