You Need to Own U.S. Stocks – Here's Why

Description

Take Stock *is the Motley Fool Canada's* ***free*** *investing newsletter. To have future editions delivered directly to you, simply* ***click here now****.*

Dear Fellow Fools,

We Canadians are a patriotic bunch. And for good reason! Can you think of a better country in the world to live? I know I can't.

But our patriotic nature occasionally blinds us from opportunity – a fact that is glaringly apparent in the world of investing.

You see, Canadian investors tend to be drawn to Canadian stocks. This is fine, to a point. The problem is, many of us go beyond that point. The Canadian market equates to just 3.5% of the global stock market … yet raise your hand if you have more than 70% of your equity portfolio tied to Canadian stocks. I suspect more than a few of you have your hands in the air.

Yes, Canada has produced its fair share of great companies over the years, and tremendous opportunities to profit are out there right now; however, there are even more great companies and more tremendous opportunities outside of Canada's relatively constricted investment borders. And the best part is, we don't even have to look very far. After all, the deepest stock market in the world lies just to our south!

In this week's Take Stock we're going to present three reasons why we Canadian Fools think *all* Canadian investors should have a considerable allocation to both Canadian *and* non-Canadian (namely, U.S.) stocks in their investment portfolios. We'll also take into account a couple of considerations as to why it doesn't make sense to completely leave our fair market behind.

1. Selection

Perhaps the best reason to reduce your exposure to Canadian stocks by diversifying into the U.S. is the makeup of the two markets. Financials, Energy, and Materials stocks account for more than 70% of the Canadian market – as represented by the S&P/TSX Composite Index. Therefore, if you're predominantly investing in Canadian stocks, there's a very good chance you're heavily exposed to these three sectors.

In contrast, the top three sectors in the U.S. market, as represented by the S&P 500, only represent about 46% of its total market capitalization. And two of the top three essentially have no representation in the Canadian market: Information Technology carries the heaviest weight in the U.S. market, while Healthcare carries the third heaviest.

By simply casting your investment lines south of the 49th parallel, you're opening yourself to a much wider range of viable investment opportunities across all of the market's sectors. The Canadian market has world-class companies in some sectors, whereas the U.S. is strong in others. Combined, they offer investors an excellent chance to build a well-diversified and highly effective portfolio.

2. Opportunity

This morning, I woke up with the help of the alarm on my **Apple** phone, washed my hair (what's left of it!) with a **Procter & Gamble** shampoo, served the kids a bowl of **General Mills** cereal and am now writing this in **Microsoft** Word on a **Dell** computer that I acquired with a **Visa** credit card. A very high proportion of the products we use and consume in our day-to-day life come from the U.S.

One of the arguments that we hear about why Canadian investors remain so loyal to Canadian stocks is that we prefer to buy what we know. This fits if we're talking about a bank or telecom product, but when it comes to consumer goods or health-care products, this argument doesn't hold much water.

Just think of the well-known companies that Canadian-only investors would have missed out on in recent years – the aforementioned Apple and Visa are prime examples but the list literally goes on for pages. The U.S. economy is home to a disproportionate share of the greatest companies in the world. To give yourself the opportunity to find these companies before the rest of the world does, you need to start shopping in the right store.

3. Global reach

Not only do we Canadians recognize U.S.-originated products, but so too does the rest of the world. The U.S. is filled with multinational corporations whose fortunes are tied to the ebb and flow of the global economy. By investing in these multinationals, we too are gaining this global exposure in our portfolios.

Now, Canada's resource-related stocks are definitely tied to the global commodities market, but you pay for this exposure in terms of volatility. And there are no doubt a number of individual companies in the Canadian market that have done a good job of developing an international business – our first two TSX-listed recommendations in *Stock Advisor Canada* are prime examples.

However, the number of Canadian companies with a significant worldwide footprint pales in comparison to the global exposure you get by investing in the U.S. market. Therefore, you're not just diversifying from one economy (Canada) to another by investing in the U.S. In fact, you'll gain much more in terms of global exposure by making this shift.

Before you start dumping your Canadian stocks, though, there are two frictional caveats to consider:

Consideration #1: Foreign exchange

Most of us live our lives in a Canadian dollar-based world. To acquire U.S. stocks requires U.S. dollars, adding an element of exchange-rate risk.

With the Canadian dollar trading right around par with the U.S. dollar at the moment, we don't really see this as much of a risk at all. Sure, the Canadian dollar could appreciate against the greenback, thus eating into the returns provided by your U.S. stocks. But in our mind, the potential returns that are available by making this move into U.S. stocks far outweigh the impact that an adverse currency move may have.

Consideration #2: Dividend taxation

Whereas currency moves are anybody's guess, the issue with dividend taxation is more concrete. Canadians receive a dividend credit (explained in more detail here) that reduces the tax burden we would otherwise face on these payments. This credit, however, only applies to Canadian corporate dividends. U.S. dividends are taxed as income – that is, at a higher rate, in non-registered accounts.

In addition, also in non-registered accounts, you'll face a 15% U.S. withholding tax on a U.S. dividend payment. Rather than receiving a dividend cheque for $1.00, you'll only receive $0.85. This can obviously impact your realized yield.

You can avoid this whole dividend tax situation by holding U.S. dividend payers in a retirement account such as an RRSP, RRIF, or LIRA. This same tax break does not apply in an RESP or TFSA. (As always, these are general points — consult your tax advisor for more specific information tailored to your individual situation.)

These registered retirement accounts — which receive relatively preferential tax treatment on U.S. dividends — represent a sizeable portion of Canadian's savings. As a result, the issue with dividend tax is almost neutralized and doesn't stand up as a great reason not to go cross-border shopping for stocks.

If you're concerned about this dividend tax situation, it's easy to mitigate: stash U.S. dividend payers in your registered retirement account and keep the non-dividend payers outside.

The Foolish Bottom Line

In our mind, the three benefits to allocating a reasonable chunk of your portfolio to the U.S. market far outweigh the frictional issues. And this is why in our *Stock Advisor Canada* service we've elected to provide members with two recommended stocks each month – one TSX-listed and one U.S.-listed.

Between our Foolish Canadian-domiciled investment team and the Fool's U.S.-focused analytical firepower, housed at Global HQ in Alexandria, Va., we think we're uniquely positioned to offer Canadian investors the best of both worlds.

Ask a Fool

We love hearing from our community of Fools and want to remind you that you can utilize our "Ask a Fool" service to put forward whatever might be on your mind. Simply e-mail us at CanadaEditorial@fool.com.

And be sure to follow us on Twitter and Facebook for the latest in Foolish investing.

'Til next time … happy investing and Fool on!

Sincerely,

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1. Investing

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