1 Big Mistake Canadian Investors Are Making

Description

Home bias—for many investors, this potentially unfamiliar term may be one of the largest factors not only minimizing their returns, but also substantially increasing their overall portfolio risk. Home bias refers to the phenomenon of investors overly favouring their own countries when allocating their portfolio geographically—that is to say, Canadians are buying too many Canadian stocks.

The research confirms this, with a recent Vanguard report finding that Canadians allocate a huge 60% of their portfolio to Canadian stocks, with only 40% to foreign stocks. With Canada only occupying 3.6% of the global market, the average Canadian stock portfolio nowhere near represents the global marketplace, which is what many experts suggest.

Home bias overexposes Canadians to a few sectors, exposes Canadians to overall risk from Canada and the TSX, and increases volatility and reduces returns. Fortunately, it is possible to gain international exposure without leaving the TSX and having to worry about currency risk by purchasing **CGI Technologies and Solutions Inc.** (TSX:GIB.A)(NYSE:GIB) and **Brookfield Asset Management Inc.** (TSX:BAM.A)(NYSE:BAM).

The importance of global diversification

Why is global diversification important? The TSX is inherently poorly diversified, both by sectors and by stocks. Currently, the top 10 holdings occupy 36% of the TSX. This is in comparison to the top 10 global holdings, which only occupy 6% of the global market.

The result is that Canadian investors are deeply exposed to individual risk of Canada's largest companies. Poor performance by one or several of these companies will affect the overall TSX, and since most Canadian stocks have a decent correlation to the overall market, Canadians are overexposed to a fairly small subset of companies.

To make matters worse, these top 10 holdings are extremely poorly diversified across sector. Four of 10 are banks, and four more are large-cap energy companies. Only two companies—**Canadian National Railway Ltd.** and **Valeant Pharmaceuticals International Inc.**—are not considered energy or financial stocks.

This revels a broader issue with the TSX as a whole. It has an outsized bias towards a few sectors. Specifically, energy, financials, and materials. In fact, 70% of the TSX is comprised of these three sectors. These sectors reflect highly cyclical, volatile commodities for the most part, and only 30% of the TSX is devoted to less cyclical industries like technology, consumer discretionary, and health care. As a comparison, the American S&P 500 is only 27% comprised of financials, materials, and energy.

This means that Canadians are not only overly exposed to a small subset of companies through overall market risk, but are also overly exposed the risk of several commodities and the financial sector as a whole, whose performance is related to the overall performance of the Canadian economy and factors like consumer borrowing, interest rates, oil prices, and real estate prices.

By adding global exposure, Canadians can achieve proper diversification. That is to say, Canadians can have a portfolio that does not move up and down together due to exposure to risk factors. Buying many Canadian companies may protect to an extent against company-specific risk, but it does nothing to protect against the overall risk of the poorly diversified Canadian market.

How to diversify

The best suggestion may seem to be to purchase equities of foreign exchanges, but in reality, this is a complex task. Investors need to worry about currency exchange rates, which can potentially reduce returns, as well as taxes. Fortunately, there are options within the TSX that provide international diversification because they have global platforms and a low correlation to the overall TSX.

One of these is CGI Technologies and Solutions Inc. CGI is a large IT company that currently obtains only 21% of earnings from Canada. 30% comes from the U.S., and the remaining half originates from diverse global sources. CGI's global nature and IT sector exposure give it a low correlation to the overall TSX, with a beta of 0.39 (the stock would only fall 0.39% for every 1% on the TSX.)

Brookfield Asset Management offers similar benefits. The global asset manager only has 11% of its assets under management currently in Canada, making it a global stock that is simply based in Canada. As a result, Brookfield only has a beta of 0.35.

CATEGORY

1. Investing

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1. NYSE:BN (Brookfield Corporation)
2. NYSE:GIB (CGI Group Inc.)
3. TSX:BN (Brookfield)
4. TSX:GIB.A (CGI)

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