



# Guide to Global Investing

Travel across the globe and you'll discover a whole new world of investment opportunities. But since even the most intrepid investor needs a map, we've put together this "travel guide" to help you navigate the opportunities and pitfalls of going global.



Venturing  
Beyond Home  
Country Bias

# Foreign Field Trips

BY ALEXANDRA JEMETZ

Heading on an extended investment trip abroad? Here are some things to think about before you leave the comfort of home.

## Preparing for your journey

Planning a vacation can take a great deal of preparation. The same goes for planning your investment allocations. For example, should you venture abroad or stay within your own country? In both travelling and investing, there are tremendous advantages and inherent risks.

Despite the benefits, investors in Canada, like in other major nations, tend to exhibit a “home-country bias” when developing portfolio allocations. Researchers have shown that this inclination has also appeared within domestic portfolios. A 1999 study by Coval and Moskowitz found that U.S. money managers preferred companies based closer to their own locations and that “one out of every 10 companies is chosen because it is located in the same city as the manager.” The most common explanation for this has been the limited information available—investors tend to buy what they know. However, with a vast network of publicly available information, this should no longer be a deterrent.

## Discovering foreign markets

Based on market capitalization, Canada represents 3% of the world market. Some would argue that this means Canadian investors should have 97% of their assets outside Canada. However, due to a strong home-country bias and the hangover of the foreign content limit, Canadians have a disproportionate percentage of their assets in Canadian investments. According to a 2007 Greenwich Associates survey, allocations to non-Canadian equities totalled 29% in 2006, up from 25% in 2004. The foreign content limit was lifted by the federal government in 2005. However, even before this ruling, investors could have circumvented the foreign content limit with the use of derivatives—but most still chose not to.

Recent studies show that the average institutional investor’s foreign content holdings are still below the old limit of 30%. However, with many advantages to investing abroad, investors should take a closer look at the reasons behind their foreign property allocations, rather than taking them for granted.

## Exploring your own country

The strength of the Canadian market and our dollar has played a role in keeping investors in Canada. The dollar has been bolstered by significant foreign and domestic interest in our natural resources. The S&P/TSX Composite Index’s annual rate of return for the past five years has been over 18%, so there has been little incentive for plan sponsors to look beyond our borders.

But keep the unique characteristics of the Canadian equity market in mind. It is cyclical and narrow, with the top 20 stocks representing 50% of the index by weight and the financials, materials and energy sectors constituting 75% (as of June 2007), according to

UBS. These characteristics can contribute to increased volatility. Historically, adding foreign securities to portfolios has reduced volatility, based on the premise that correlations between global markets and currencies are low and will remain that way.

## Navigating the risks

Even with greater access to market data, investing in other countries and currencies carries its own set of risks.

**Currency Risk:** Currency can be passively managed, actively managed or not managed at all. How to approach the currency decision depends on whether the plan sponsor wants to take that kind of risk or prefers risk exposure from other asset classes.

**Interest Rate Risk:** With foreign fixed income, keep in mind that interest rate risk is large and hedging may be beneficial. Domestic interest rates have the largest impact on a plan’s assets and liabilities and should be managed with the most attention.

**Inflation Risk:** Domestic equity acts as a better hedge against inflation than foreign equity; however, a depreciating domestic currency and price increases by foreign firms both contribute to imported inflation, which should not be ignored.

## Following your itinerary

All of the points above must be taken into account in order to determine the appropriate allocation to foreign investments. The most crucial step is to decide the main goal of your pension plan: is it to maximize performance or reduce risk? You’ll also want to consider the plan’s demographics, funded status, and risk and return objectives. For example, if the plan’s goal is purely risk control, a defensive portfolio may have a large home-country bias. Protecting capital from high interest rates and preventing erosion of the portfolio value from inflation entail matching assets with liabilities in the same currency. As return maximization becomes more important, portfolios become less defensive and will have greater allocations to international investments.

It’s difficult to take your investment journey abroad when you’re used to the comfort of investing in something familiar. But as companies and economies become truly global in scope, it’s inevitable that investors’ allocations to non-domestic assets will rise. The real question is, how much will change and how quickly? If the past is any predictor of the future, it will change, but slowly. **BC**

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# Hot Stops for Stocks

Discovering the Wide World of Global Equity.

BY ROBERT BRUNELLE

Tired of hearing about the same old boring Canadian bank or energy stock? See the world and invest in stocks of a major pharmaceutical company (e.g., Merck, Novartis) or an exciting technology company (e.g., Intel, Toshiba). Travelling abroad expands the opportunities available to you and can provide portfolio diversification.

## Top destinations

Currently, the three major global equity destinations are the U.S., Europe and Asia. For your travels outside Canada, plan to spend about 50% of your time in the U.S., 35% in Europe and 15% in Asia. These percentages correspond nicely to the weight of each of these regions in the Morgan Stanley Capital International (MSCI) World Index (excluding Canada).

For more adventurous travellers, emerging markets (EM) may provide a more rewarding trip. If you wish to invest in these exotic locations, allocating 10% of your travel time (corresponding to the weight of EMs in the MSCI All Country World Index) might be a good benchmark. Be aware that these countries have been hot stops recently. At the end of June 2007, the MSCI Emerging Market Index had a five-year annualized return of 21.6% and a one-year return of 39.1%. You may want to consider waiting until the place cools down a bit before investing there.

## Choosing your travel agent

Selecting the proper “travel agent” (i.e., your money manager) will help make your trip more enjoyable. Money managers come in many varieties with a broad range of services. “Top-down” managers focus more on the “big picture” (i.e., countries, currencies and sectors), whereas “bottom-up” managers focus on specific attractions (i.e., individual stocks). Other approaches concentrate on growth versus value or large capitalization versus small capitalization.

You may be led to believe that in a global environment, region or country selection is of minimal importance. But would you say that visiting a church in Spain is the same as visiting a mosque in Israel or a Buddhist temple in Japan? The same is true for stocks. If the region wasn't an important factor, you would expect the returns of a given sector to be more or less the same across all regions. However, if you look at the table below, you'll see

Sector Returns for MSCI Indices						
2005 (in local currencies)			2005 (in Canadian dollars)			
	Healthcare	Financials	Telecoms	Healthcare	Financials	Telecoms
North America	7.2%	7.2%	-5.1%	4.5%	4.8%	-7.4%
Europe	29.2%	25.6%	-2.0%	8.7%	4.8%	-17.7%
Pacific	25.6%	40.9%	8.2%	6.1%	21.7%	-7.0%
2006 (in local currencies)			2006 (in Canadian dollars)			
	Healthcare	Financials	Telecoms	Healthcare	Financials	Telecoms
North America	6.2%	18.5%	35.5%	5.8%	18.1%	35.1%
Europe	4.1%	22.8%	19.4%	15.2%	37.3%	34.0%
Pacific	29.6%	8.5%	9.2%	29.1%	10.2%	9.2%
			Best region Worst region			

Source: MSCI

that picking the right regions—or selecting a manager who can identify these regions—has a significant impact on returns.

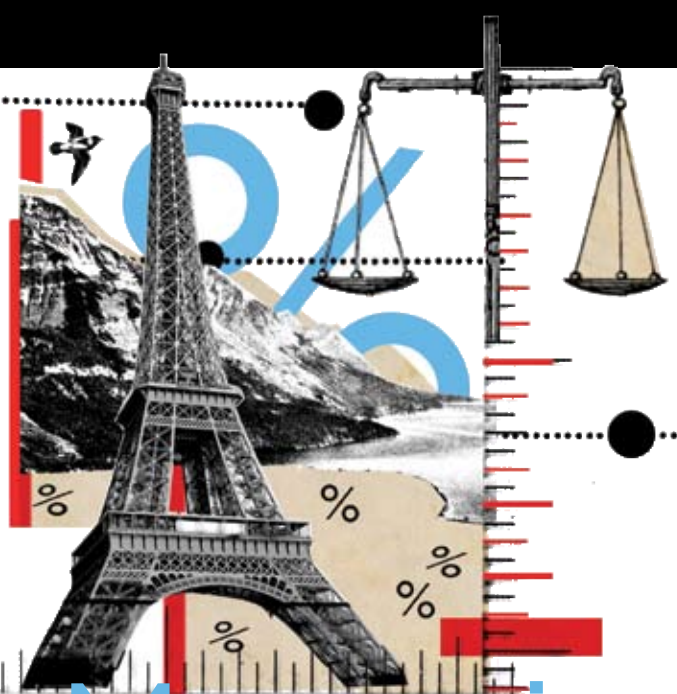
## Getting around

The vehicle of choice for travelling abroad is the commingled fund, which offers the advantages of diversification and ease of use. But travellers beware—not all commingled funds are created equal. Always ask for the latest trust agreement and verified financial statements of the fund. In these documents, you should find the answers to the following important questions.

- 1) What is the fund's investment policy?
- 2) What are the roles of the trustee, the custodian and the manager?
- 3) What are the expenses charged to the fund (Management Expense Ratio)?
- 4) When can I purchase and redeem units?
- 5) Are there costs associated with purchases and redemptions?
- 6) What is the turnover ratio?
- 7) Is there a security-lending policy?
- 8) Is there a proxy-voting policy?

Having a separate account where managers directly purchase stocks (instead of purchasing units, as in a commingled fund) is an interesting travel option for larger plans. A separate account offers greater flexibility, since the manager can more easily tailor the portfolio to meet your specific needs. You'll also benefit from more extensive and detailed reporting. But the added flexibility and transparency of travelling “first class” comes at a cost. If you're not sure which option to choose, consultants and custodians can help you determine the travel arrangements that will work best for you. **BC**

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## Travel Tips for Selecting Your International Benchmark

# Measuring Up

BY SARAH BUTCHER

With the removal of foreign content restrictions and the growing trend toward globalization, many Canadian plan sponsors are looking abroad for investment opportunities. If you're looking to expand your international equity portfolio, determining which benchmark to use is an important starting point. The benchmark choice frames the expectations of the investment manager and can have a significant impact on the composition and characteristics of a plan's international equity exposure.

### Making your travel arrangements

What should investors look for when going global? Consider these "travel tips" when evaluating international benchmarks.

**Completeness:** Does the index accurately reflect the overall investment opportunity, in terms of both country and company coverage? If not, it's more difficult to assess the risk-adjusted performance of managers who wander beyond their target benchmark into other asset classes. Also, the invested portfolio may not accurately reflect the intended asset allocation policy.

**Investability:** Does the index include only those securities that can be purchased by foreign institutional investors? If not, it can be difficult to distinguish between tracking error caused by poor portfolio management techniques and that caused by simply choosing an uninvestable benchmark.

**Clear, published rules and governance structure:** How transparent and publicly available are the rules that govern the various indices? Clear rules provide predictability to both the investment manager and the plan sponsor and make it easier to anticipate how changing market conditions will be reflected in the benchmark.

**Accurate and complete data:** For an index to be useful, return data must be accurate, complete and readily available. Also, because performance analysis is one of the main motivations for using indices as a benchmark, extensive historical data must be available.

**Acceptance by investors:** An index that is well known and widely used gives an investor comfort in the integrity of the index and the ability to make peer group comparisons.

**Availability of crossing opportunities and derivatives/tradable products:** Indices that are widely used, especially within pooled investment vehicles, offer potential cost savings because they provide crossing opportunities among large institutional investors. In addition, the availability of listed derivative products and exchange-traded funds can further benefit asset owners and managers.

**Turnover and transaction costs:** In general, the lower the turnover, the lower the rebalancing costs. A broader benchmark favours lower turnover, while an index that works within a narrowly defined market has greater turnover and transaction-related costs.

These seven key areas of assessment may be the most important factors in determining which international benchmark to use, but they are certainly not the only factors to consider. Other possible factors could include closing price convention, foreign exchange treatment and timing.

To further complicate the decision-making process, no single benchmark can meet all of the above criteria because several of the criteria are mutually exclusive. The most effective strategy is to establish your preferences relative to the different factors, then select the benchmark that best meets those preferences. Consider these four key trade-offs: completeness versus investability; frequency of rebalancing versus costs of turnover; adjustment for float versus transaction costs; and objective and transparent rules versus flexible judgment-based methodology.

### Where to travel

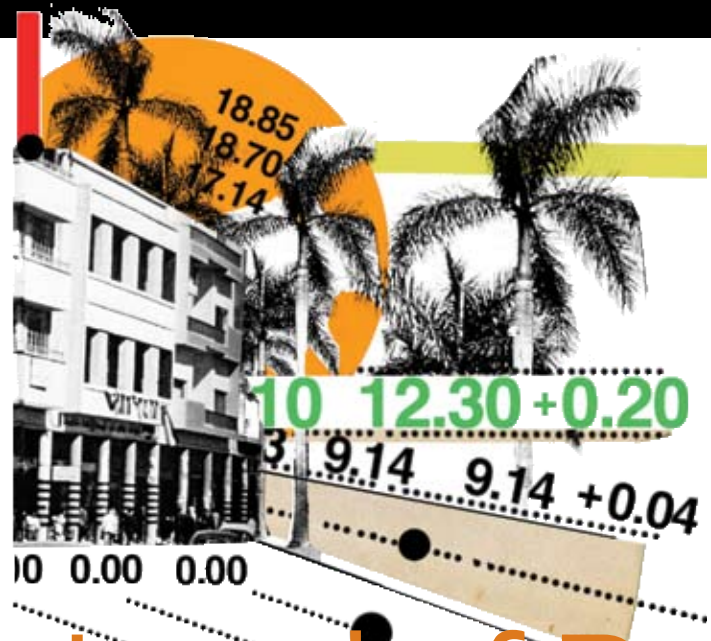
While there are an increasing number of high-quality international benchmarks, the Morgan Stanley Capital International (MSCI) benchmarks enjoy a significant "first mover" advantage and continue to be the international indices of choice in North America. In Europe, FTSE Group's homegrown appeal makes its indices the most popular choice, although MSCI is also very prominent.

The recent trend in Canada has been away from separate U.S. and EAFE (Europe, Australasia and Far East) benchmarks toward global (U.S. plus EAFE) and all-country indices, including both developed and emerging markets (EMs). Per MSCI, EMs now make up approximately 8% of the global market capitalization, so it's no surprise that investors are refocusing on this market segment.

South of the border, the MSCI All-Country World Index ex-U.S. benchmark is becoming many investors' benchmark of choice, particularly for foundations and endowments. This trend has positive implications on the expected international fund inflows to Canada, since contrary to the EAFE benchmarks, our domestic market has representation in all-country indices.

Markets are becoming increasingly global in nature, and staying within your own country's borders can limit the diversity of your portfolio. Finding the right international benchmark requires careful consideration, but with a little research, travelling abroad to expand your investment portfolio may be well worth the trip. **BC**

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Navigating  
Global Fixed  
Income  
Opportunities.

# Land of Bonds

BY MARLENE K. PUFFER

The recent epidemic that started with U.S. subprime and infected all major financial markets has taken a particularly devastating toll on money markets and fixed income credit in Canada and abroad. Portfolios holding more than their benchmark weight in corporate bonds have suffered from poor performance. But skilled managers now have access to more relative value opportunities in our newly volatile home market. However, global opportunities abound, so plan now to get the best deals as markets adjust to recent events.

## Top destinations

Europe, Australia and Asia have the most developed and diversified bond markets. Emerging markets (EM) have been a hot spot and have outperformed other destinations in the past decade, even with the recent turmoil. Credit conditions have improved, and many former EM countries are now part of some investment grade benchmarks (e.g., Russia and Mexico). Monitor your benchmark selection and risk tolerance carefully. Be prepared for more adventurous travel in the EM world, which may still be subject to political upheaval and contagion. Also, sovereign EM debt is giving way to corporate issuance, which requires more due diligence.

Rather than committing a fixed portion of your assets to EMs, invest a small allocation (up to 5% per allocation, with an overall cap) as part of a global mandate.

## Travelling alone or in a group

Do you take the group tour with a global manager who can invest across markets and asset classes (e.g., sovereign debt, high yield) or take along your backpack and tour book and choose niche players in specific sectors and markets? Choosing specialist managers means that more asset allocation decisions need to be made by your Board. Giving the asset allocation responsibilities to a manager, however, may be the best solution for many plans.

## What to pack

Review your SIP&P (Statement of Investment Policies & Principles) thoroughly, outlining approved and disallowed assets, countries and strategies. Ensure that currency hedging policies are well defined. And if you plan to make use of derivatives, clarify the definition of *leverage*. For example, many global managers use swaps and futures rather than cash bonds to execute duration strategies and invest the asset in “cash plus” strategies such as lower quality or six- to nine-month securities rather than staying in the traditional short-term AAA cash markets.

## Budget

Be prepared for higher active management fees. Expect 50 basis points or more for an active global manager.

## Investment Travel Checklist

**Board education and SIP&P:** Asset classes, strategies, derivatives, currency risk, leverage, risk/reward, benchmark.

**Benchmark selection:** Domestic liabilities, domestic benchmark, foreign benchmark hedged to CAD dollars or foreign benchmark unhedged.

**Fees:** Active fees are higher than most domestic managers.

**Domestic versus foreign managers:** Many domestic managers have the expertise, team and tools for global yield curve strategies, high-quality credit and some derivatives, and a few for high-yield bonds. Foreign managers may have larger teams to support credit strategies across more markets.

**Specialist versus global managers:** Niche players require the Board to make more asset allocation decisions. Bigger players may add value through sector selection.

**Reporting:** Look for detailed performance attribution reports to determine how your manager adds value.

## Shopping around

Canadian credit sectors are poorly diversified, with nearly 50% in the financial services industry. Global markets offer a wide range of sectors, products and strategies that can improve the portfolio risk/reward profile compared to a purely domestic selection.

U.S. subprime mortgages are lurking in many structured credit products (e.g., Asset-backed Commercial Paper), and poor disclosure makes these sectors worrisome. However, higher-quality foreign bonds relating to prime mortgages can still be an excellent source of high-quality assets.

## Travel log

Reporting to the Board and monitoring managers become more complex as you diversify. Ask managers for performance records.

With appropriate diversification, global strategies can reduce portfolio risk and potentially yield significant rewards. Whether you're a first-time adventurer or a seasoned traveller, preparation is key. **BC**

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