Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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Inside this Issue

Breaking the Home Country Bias

We see the benefits of diversification in many places, like nature and society. On the former, genetic diversification allows populations to effectively adapt to changing environments and improve their odds of fighting disease. As for societal benefits, these include individuals gaining new ways to solve complex problems, the acceptance of differing opinions and perspectives and the promotion of respect for others. In this beautiful country many call home, Canadians welcome over 300,000 newcomers every year, adding to a rich tapestry of cultures, languages and traditions. Therefore, it begs the question: why do investor portfolios typically shy away from the known benefits of diversification?

The average Canadian investor allocates about 60% of their holdings to domestic securities. The home country bias plays a significant role in explaining an investor's unwillingness to increase regional diversification. This bias refers to an investor's tendency to favour companies from their own country over those from other countries or regions. Investors feel a certain amount of comfort and familiarity investing in a company to which themselves may be a customer.

Home country bias is not a problem exclusive to Canada as studies have shown investors around the globe exhibit the bias. However, it is a particularly acute issue for Canadian investors given a market concentration in financials, energy and materials. The prospects for these three sectors can influence every other sector, both positively and negatively, within the Canadian market. Further, stock concentration is a significant issue for Canadian investors as the top 10 stocks by market cap within the S&P/TSX Composite Index (S&P/TSX) represent over 30% of the index; compared to a world index, this number is closer to 8%. From a global standpoint, Canada also only represents about 4% of the global equity market; thus, a Canadian-focused portfolio is essentially excluding 96% of all other possible investments. While the barriers to gaining international exposure were high in the past (government restrictions on foreign investments, foreign taxes, transaction costs and currency considerations), the proliferation of low-cost passive ETFs has removed many of these barriers. Investors can now easily gain all the benefits of diversification with the purchase of one product for exposure to foreign markets, commodities or even bonds.

Interestingly, regular investors are not the only ones that fall victim to this bias as studies have shown money managers also exhibit some measure of preference for geographic proximity. In one such study, US money managers displayed a preference for investing in US companies with headquarters close to the manager's office. This tendency to invest in one's own backyard is counter to what modern portfolio theory has taught us about the benefits of diversifying across uncorrelated assets. Within a portfolio, including securities that have a tendency to move counter to the existing holdings is an effective way to reduce overall portfolio volatility. In fact, adding the right combination of assets not only reduces wild swings in the portfolio's value, but can also improve the overall potential return profile.

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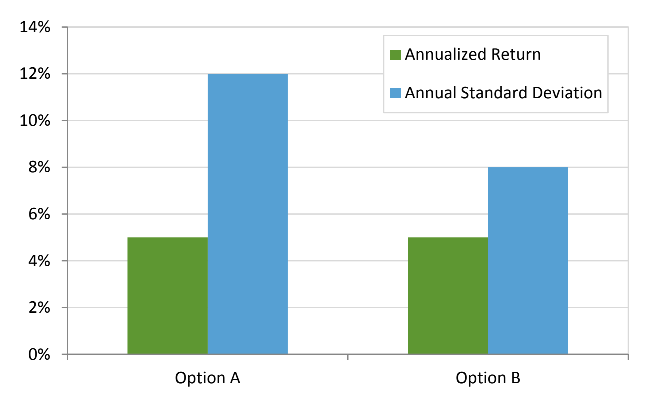
The Efficient Frontier

As the average Canadian investor allocates the majority of their investments to domestic securities, many are missing the potential diversification benefits from increasing exposure to other regions.

Option A & B: Same Return, Different Volatility

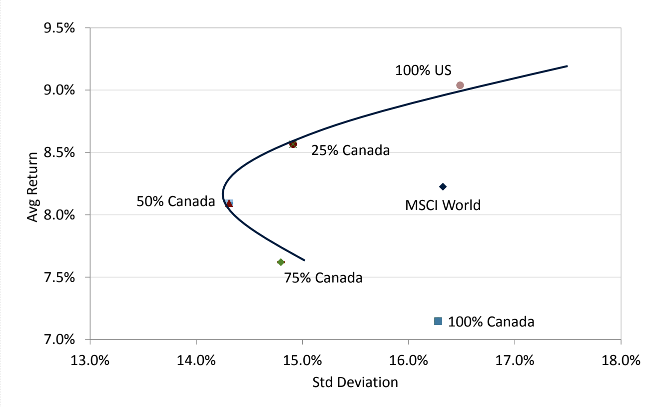


Source: Raymond James Ltd.

Consider the two options above; an investor may be indifferent between both options as the returns are identical. However, we illustrate the volatility (standard deviation) of both options. In theory, an investor should prefer an equivalent unit of return given a lesser unit of volatility. Under this assumption, there should be a natural gravitation toward option B as the ultimate goal of diversification is to achieve a superior return with the same/lesser level of volatility.

Now let's consider a real world example. In the chart in the next column, we illustrate the average annual price returns and volatility for the Canadian and US markets over the past 47 years. We also calculate a few different Canada/US combinations, which creates a curved shape known as the efficient frontier. In our case, the efficient frontier is a set of optimal Canada/US portfolios that offer the highest expected return for a defined level of risk. An investor holding a 100% Canadian portfolio falls well below the optimal set of portfolios while experiencing significantly more volatility. By adding US exposure, at the expense of Canadian exposure, the portfolio experiences considerably better overall portfolio returns with significantly less volatility (up until a point). One way we can determine the optimal mix is to calculate a Sharpe ratio, which measures the unit of return versus the unit of risk. A higher Sharpe ratio indicates a superior level of return for a given level of risk. In our scenario, a portfolio with a 25% allocation to Canada results in the best risk/reward, or Sharpe ratio. As we continue to decrease the Canadian exposure, the Sharpe ratio falls given the US market exhibits higher levels of volatility.

Canada & US Simulated Efficient Frontier



Source: Bloomberg, Raymond James Ltd.
Return data is calendar year performance of Canada (S&P/TSX Composite) and the US (S&P 500) in Canadian dollars. Annual returns from 1972-2018.

One of the tenets of diversification is the uncertainty surrounding future returns. By actively placing all your eggs in one country basket, an investor is unwittingly making a risky bet. For example, if we told you 15 years ago that the US would become energy self-sufficient while Canada would struggle to build additional oil export capacity you would have told us to go jump in a lake.

The future is unpredictable and the fortunes of countries can change in a matter of years. Having exposure to multiple regions can reduce the concentration risks associated with investing in one country. Further, establishing exposures outside of Canada can ease the future decisions to increase or decrease regional exposure due to a change in the outlook. This is because having a diverse set of options makes it easier to allocate capital to an existing position, rather than establishing a new position.

Canada is one of the best places to live, work and play. According to the Organisation for Economic Co-operation and Development (OECD), Canada ranks highly on a broad range of measures among the world's best-performing countries. While we are proud to be Canadian, this should not limit our investment universe. The vast majority of Canadians embrace diversity and this philosophy should carry across to one's investment process.

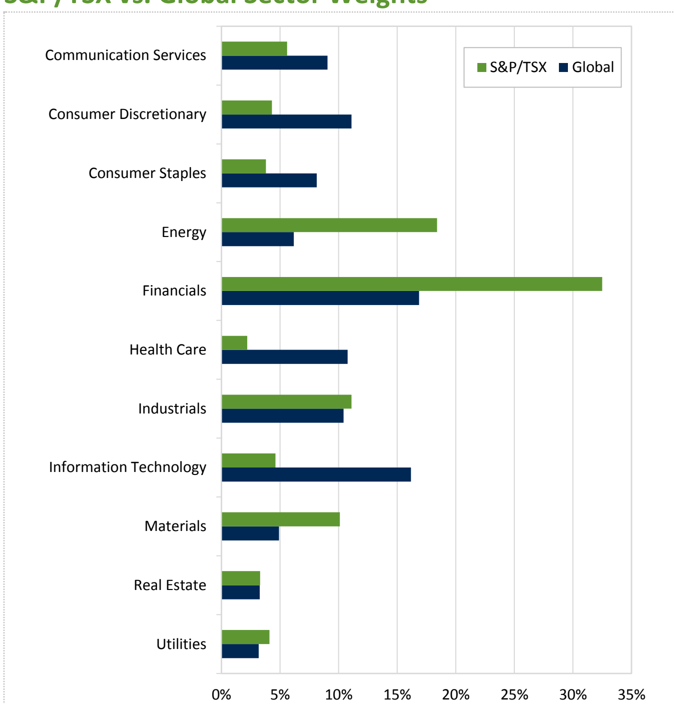
Jason Castelli, CFA, VP
Head of Investment Strategy

American Diversity

Canadian investors have home market access to many world-class companies, especially in the energy, materials and financial sectors. However, when it comes to higher growth sectors, there is a big drop off. Our technology sector is healthy and growing but it is still tiny in comparison to the rest of the Canadian and global markets. Moreover, traditional, large cap health care stocks are almost non-existent due to our socialized health care system. These two sectors make up 4.6% and 2.2%, respectively of the S&P/TSX. However, using the iShares MSCI AWCI (All Country World Index) ETF as a global proxy (it includes the 23 largest developed economies and 28 emerging markets), these two sectors comprise 16.2% and 10.8%, respectively.

Putting it in chart form shows an even starker differential between the diversification of the Canadian and global stock markets. Investing based off an S&P/TSX benchmark would give you twice the global exposure to financials and materials and triple for energy; while less than half the exposure for technology, consumer discretionary, communication services, and consumer staples. Only our industrials, real estate and utilities sectors are in line with the global average.

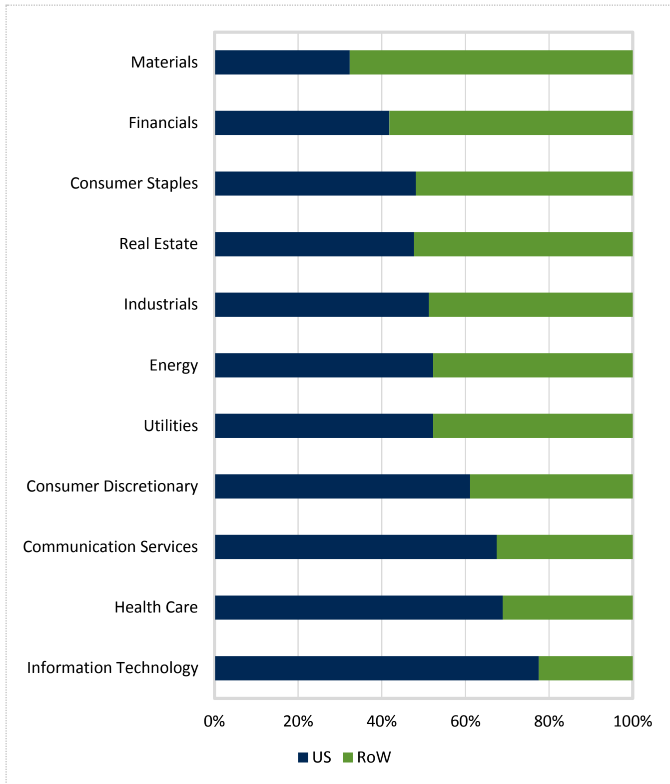
S&P/TSX vs. Global Sector Weights



Source: Bloomberg, Raymond James Ltd. As at April 30, 2019

For Canadian investors looking to reduce their home country bias, there is good news: the world's most diversified stock market resides just below the 49th parallel. The US economy is not only the largest in the world but also one of the most dynamic and diversified. In fact, certain areas of the global economy are dominated by the US. Using the same global benchmark, US public companies comprise more than two thirds of the value of publicly traded market caps for the information technology (78%), health care (69%) and communication services (67%) sectors. Not only are these critical parts of the global economy, they are also amongst the most profitable and fastest growing, making them essential parts of most investors' portfolios. Investing in the US market gives broad access to these sectors and their market leaders.

US Share of Global GICS Sectors



Source: iShares, Bloomberg. As at March 31, 2019

Another advantage of using US securities for diversification purposes is simplicity. Although there is the issue of foreign exchange, many Canadian investors are comfortable buying and selling US dollars and can do so with minimal costs through their investment firm. As well, from a tax perspective, investing south of the border has much less friction than other jurisdictions. A great example of this is the tax treaty between Canada and the US, which allows US stocks held in RRSPs and RRIFs to avoid withholding taxes on dividends.

American Depository Receipts (ADRs)

American depository receipts or ADRs are another unique wrinkle in the US stock market that can allow Canadians to gain geographical diversity. Because of the size of US capital markets, many multinational companies will list their shares on NYSE or NASDAQ to gain direct access to institutional and retail American investors. This is largely done through ADRs, which allow the foreign issuer to offer stock that trades on a US exchange in US dollars. Some examples of global leaders with that have ADR's listed on the NYSE are China's Alibaba (BABA-US), Japan's Toyota (TM-US) and the UK's Unilever (UL-US). The table to the right shows the 20 largest ADRs by market cap and their respective home countries.

The "Non-Canadian Canadian" alternative

For investors who are still not willing to move beyond the Great White North for diversification, there is an alternative: "Non-Canadian Canadian" (NCC) companies. We use this to describe Canadian domiciled and listed companies that generate a majority of their revenue from other countries. In cases like Alimentation Couche Tarde (ATD.B-T), Manulife Financial (MFC-T) or CGI Inc. (GIB.A-T), these are domestic success stories that have grown to a size where they need to venture beyond our borders to maintain growth. While in other cases, like Waste Connections (WCN-T), Gildan Active Wear (GIL-T) and Kinaxis (KXS-T), the companies' business models are built specifically to operate in large foreign markets (primarily the US).

Investing in NCCs effectively diversifies the end market of the stocks held in a Canadian portfolio without having to exchange loonies for greenbacks. The investor still has indirect exposure to exchange rates fluctuations but this is administered within the companies' operations, as opposed to investors' accounts. The table below shows a list of NCCs held in our Guided Portfolios that gain the highest percentage of their revenues from outside of Canada.

20 Largest ADRs by Market Cap

Company		GICS Sector	Mkt Cap (US$ bln)
Alibaba		Technology	$483.3
Tencent		Technology	$473.2
ICBC Bank of China		Financials	$297.4
Nestle		Consumer Stap.	$293.4
Royal Dutch Shell		Energy	$258.3
Ping An Insurance		Financials	$230.6
Taiwan Semiconductor		Technology	$227.3
Roche Holdings		Health Care	$225.2
China Construction Bank		Financials	$223.8
Novartis		Health Care	$206.9
Toyota Motor Corp		Industrials	$202.0
LVMH Moet Hennessy		Consumer Disc.	$195.4
China Mobile		Comm. Services	$194.8
Agricultural Bank of China		Financials	$191.5
Petrochina		Energy	$191.4
Anheuser-Busch Inbev		Cons Disc	$177.7
HSBC Holdings		Financials	$175.2
Unilever		Cons Disc	$171.8
Bank of China		Financials	$161.8
SAP		Technology	$158.5

Source: Bloomberg, Raymond James Ltd.

Investing in NCCs has long been an investment theme we promote as a means for Canadian investors to geographically diversify their portfolios. It allows Canadians to access foreign markets without leaving the S&P/TSX. That said, it still cannot replicate the access to mega-cap, globally dominant names available on the US exchanges. Thus, using a combination of NCCs, US equities and ADRs is a good way to internationally diversify equity portfolios.

Robert Mark, CFA
Portfolio Manager

Non-Canadian Canadian Companies

Company Name	Ticker	Industry	USA	Europe	Asia/Other	Canada	% Foreign
Kinaxis	KXS	Technology	69%	22%	8%	1%	99%
CCL Industries	CCL.B	Industrials	38%	32%	27%	3%	97%
Gildan Activewear	GIL	Cons. Discretion.	85%	10%	0%	4%	96%
Algonquin Power	AQN	Utilities	91%	0%	0%	9%	91%
Open Text	OTEX	Technology	50%	26%	12%	12%	88%
Aliment. Couche Tarde	ATD.B	Cons. Staples	66%	20%	0%	14%	86%
Waste Connections	WCN	Industrials	85%	0%	0%	15%	85%
CGI Inc.	GIB.A	Technology	15%	30%	40%	15%	85%
Colliers International	CIGI	Real Estate	51%	15%	19%	15%	85%
WSP Global	WSP	Industrials	25%	30%	27%	18%	82%
Manulife Financial	MFC	Financials	34%	0%	32%	34%	66%

Source: Bloomberg, Company Reports

A Buyer's Guide to Shopping for Equities Outside of Canada

It has never been easier to add foreign equity exposure to your portfolio than it is today. From buying a basket of securities that represents 99% of the global equity investment opportunity set to selecting particular geographic regions or sectors, the average investor's ability to customize their global exposure has also never been as robust and cost-effective as it is today. However, with all of the choices come the inevitable tough decision of determining what to buy. To help with the challenge of customizing your global exposure we have broken the process down into two discrete steps. The first step is deciding how active you as an investor want to be in deciding on asset allocation. The second step is to determine how active you want your investment manager to be. Once you have answered the first question, the second step falls nicely into place.

Step one, how active do you want to be? The important part of this question is deciding whether you want to have global exposure or international exposure. Now that might seem like semantics, but what we are doing here is applying the first level of constraints to our manager - where they are allowed to invest. Global exposure encompasses, as the name suggests, the entire world. Global managers or products typically look at a country's proportional market cap relative to the global economy to determine their exposure to that market. Meanwhile, international equities are simply stocks domiciled outside of North America (i.e. exclude equities from both Canada and the United States). The following sections walk through the benefits of both global and international allocations and our preferred products in each space.

Going Global

If you do not want to make specific calls on countries or regions, a global mandate is for you. The benefit of allocating globally is you do not need to make a call on whether you think a particular geography will outperform or underperform; instead, you are outsourcing this decision to a product manager or taking a passive approach entirely. The drawback however is that without geographic constraints on the product it is difficult to layer in multiple managers, say with different investment styles, to manage your global asset allocation. The reason is that you can start to have unintended geographic concentrations if all of your managers are overweight the same geographic region; which in turn reduces the benefit of global diversification. Including multiple global managers is certainly possible, but requires more oversight to ensure you are not taking major bets unintentionally.

From a passive index approach, our pick is the iShares Core **MSCI ACWI ex-Canada ETF (XAW-T)**. This provides broad based equity exposure to the MSCI All Country World Index excluding Canadian equities. From an active prospective, we would highlight both **Capital Group Global Equity** and **Edgepoint Global Portfolio**. Capital Group applies their unique multi-manager approach to picking global companies with separate management teams responsible for their own sleeves of the portfolio. This approach helps to reduce groupthink and the unintended biases that can come as a result of it. Edgepoint on the other hand has been a consistently solid manager that focuses on in-depth fundamental company-specific research and stock picking with a view to long-term concentrated portfolios.

International Allocations

Choosing to go the international route makes more sense for those that want to construct their portfolio from the ground up controlling geographic allocations and sector exposures. Allocating to international equities provides a high level of customization to overweight and/or underweight both considerations. However, this customization means you are internalizing not only the investment decision, but the asset allocation and strategic outlooks for these regions as well. The Quarterly PCS Asset Allocation report provides an excellent starting point for determining your preferred asset allocation, but this is an important consideration for those looking to explore international equities.

For a passive index exposure, we believe investors should consider **iShares Core MSCI EAFE ETF (XEF-T)** which provides broad exposure to the investable equity market index outside of Canada and the United States. For a more granular approach to EAFE (Europe, Australasia, Far East) look to **BMO MSCI EAFE ETF (ZEA-T)**, with the key difference being that ZEA-T excludes emerging markets. In terms of active management, we would take this opportunity to highlight the **Sun Life MFS International Value Fund**. This fund, sub-advised by MFS Investment Management (MFS), consistently rises to the top quartile of our proprietary quant screen through Morningstar. As an organization, MFS specializes in detailed, bottom-up research that in the past has proven to result in picking quality companies that provide strong upside capture while protecting on the downside.

Spencer Barnes, MSc., CIM
AVP, Mutual Fund & ETFs

Searching For Short-Term Yield

Persistently low interest rates remain a source of frustration for conservative investors wishing to earn decent income when tucking away cash for short periods. In mid-2018, the narrative appeared to be shifting after seeing eight straight months of rising Canadian bond yields – the longest streak in more than 20 years. However, waning sentiment on global growth has brought short-end yields close to 2018 lows. With this as our backdrop the question remains: what are some low-risk options available to investors?

Chart 1: Canadian Yield Curve Flattens

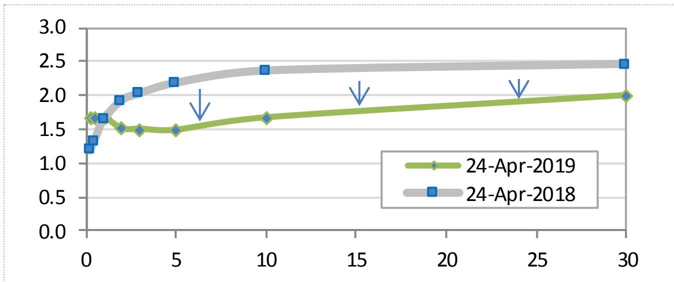
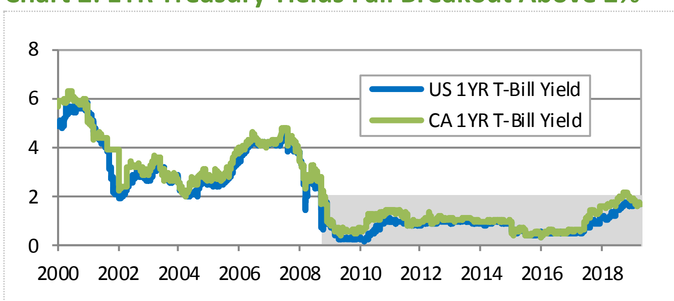


Chart 2: 1YR Treasury Yields Fail Breakout Above 2%



Source: Bloomberg, Raymond James Ltd.

Traditional strategies for enhancing yield in the fixed income space typically include extending term to maturity or taking on credit risk; however, these may not be attractive options in the current environment. The shape of a normal yield curve is upward sloping, meaning that investors are compensated for the risk of investing in longer-term instruments. As we know, parts of the Canadian government yield curve have been inverted since December, particularly from the short end to the belly. This means that extending maturity in a Canada government bond yield from 1-2 years to 3-5 years could actually result in a lower yield. Taking on credit risk in the short term (i.e. investing in corporate bonds) can provide a boost in yield; however, credit spreads in Canada and the US are near multi-year lows. Fixed income investors long starved for yield have flocked toward short corporates for yield, resulting in high demand for these instruments that has eaten away at the yield pick-up.

Where Should Investors Turn?

In the current environment, we believe Guaranteed Investment Certificates (GIC), Bankers' Acceptances (BA) or Provincial bonds are the preferred solution for a conservative investor. On average, the yield pick-up in moving from a 1-year Canadian bond to a 1-Year GIC issued by a Canadian bank is 47 bps. The pick-up in yield when considering GICs issued by credit unions is even more attractive, with an average yield 54 bps better than Canadas. Investors should be mindful that the trade from Canadas to GICs does come with its own risks to consider. By switching from a government-backed instrument to one issued by a bank or credit union one must consider the credit risk of the issuer (check with your financial advisor to determine if a particular GIC investment is eligible for insurance). Another caveat is liquidity given that GICs typically do not allow redemption before maturity. Investors that do require liquidity should consider BAs, which come in terms ranging from 30 days to 1 year. These instruments, issued by Canadian banks, offer yield pick-ups of roughly 9-28bps above Canadas depending on maturity. Moreover, should an investor want to switch their BA position back to cash before maturity there is a readily available secondary market for these instruments. For investors with their eyes fixed on slightly longer maturities beyond the scope of a BA, we recommend Province of Ontario bonds. With its DBRS AA-low credit rating and the fact that Ontario comprises nearly 50% of all Provincial issuance, these instruments can provide a relatively safe and liquid method for picking up yield over Canadas.

Average Basis Point Pick-Up Over T-Bills

Tenor	BA ($C)	BA ($US)	Tenor	Prov. Of Ont ($C)	Prov of Ont. ($US)	GIC Bank / Lifeco ($C)	GIC Credit Union ($C)
1M	9	2	1YR	2	15	47	54
2M	10	3	2YR	18	14	64	72
3M	12	9	3YR	18	19	71	76
6M	17	9					
12M	28	14					

Source: Raymond James Ltd., Data as of April 26, 2019

Putting US Dollars to Work

For investors with US dollars to tuck away for a short period the opportunity is somewhat the same. Canadian issuers of GICs rarely offer US dollar versions and those that do typically issue only to large institutional investors. However, the

Canadian banks do issue BAs in US dollars, and the pick-up over equivalent US T-Bills is just as attractive. For those wishing to extend past one year, Ontario Provincial $US bonds offer a low-risk option to pick up yield. With roughly 25% of Ontario's CA$335bln outstanding debt issued in $US there are plenty of liquid bonds to choose from.

Be Wary of Currency Risks

Consensus estimates among FX strategists across the street predict the Loonie will remain on the back foot against the USD for the next 6-12 months. Borrowing Canadian dollars for conversion into US dollars and then investing in short-term fixed-income instruments (i.e. carry trade) is a trade that has worked in recent months primarily due to a couple reasons. While short-end rates in Canada have been somewhat lifted in the past few months they have not managed to close the gap with our neighbours to the south. Furthermore, with a swath of unsettled trade disputes lingering on the sidelines, global investors have generally had little confidence in placing large directional bets on major currency pairs. This has resulted in G7 currency volatility tracking near historic lows.

Despite the recent track record, looking forward we do not recommend this strategy for those wishing to invest money short term on a risk-free basis. USDCAD 3-month risk-reversals, a widely used metric for gauging expected volatility of the currency pair, have been inching higher since the Bank of Canada's dovish statement. Moreover, without access to the sophisticated hedging tools available to institutional investors this trade could turn negative in a flash.

Ultimately, when looking toward low-risk, short-term parking spots for cash in this low yield environment, we believe there are better opportunities available relative to Government of Canada bonds. Investors should consider various options based on their tolerance for risk, time horizon and liquidity needs. Whether putting $CA or $US to work, the least amount of risk lies with remaining within your original currency rather than utilizing an unhedged carry trade.

Chris Antony, CFA
Foreign Exchange & Fixed Income

Using Structured Products to Diversify

Structured notes can be a great way to gain exposure to a variety of underlying and can be designed to enhance the overall risk/return profile. They can be fully customized to meet an investor's specific view on the direction of a chosen underlying while taking into account their specific risk/return objectives.

An example of a note that could be designed to benefit an investor who is bullish on the Canadian banks or simply wants to have some exposure to the sector, while protecting their invested capital at the same time, is a principal protected note (PPN) tied to a basket of Canadian banks.

If we examine a PPN that is 5.5yrs in term and is tied to a basket of equal-weighted banks with a participation rate of around 150%, we can see how the payoff profile might be attractive to some investors through various potential scenarios:

Sample Return Scenarios

Bank Performance to Maturity	Investor Receives
5%	Principal + 7.50% return (1.3% ann.)
20%	Principal + 30.0% return (4.9% ann.)
40%	Principal + 60.0% return (8.9% ann.)
Negative	100% of Invested Principal

It's worth noting that the holder of most PPNs, including the one above, does not receive the underlying dividends associated with the underlying basket and that the performance of the note is tied to the price performance of the underlying basket, not the total return performance.

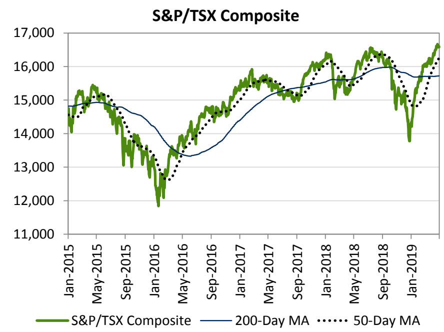
As illustrated, a principal protected note can be an excellent way to achieve a variable return tied to an underlying of choice while keeping an investor's capital fully protected. PPNs are often positioned as a fixed income alternative within client portfolios and can provide the potential to earn a variable return that is much greater than the return on traditional fixed income instruments in the current environment.

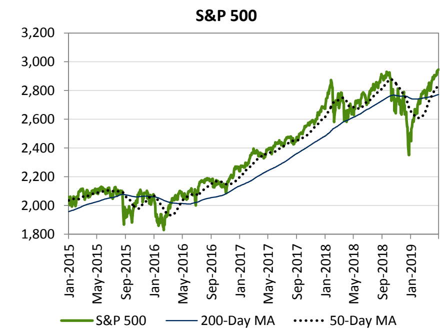
All the risks and benefits associated with structured notes in general should be carefully considered before purchasing.

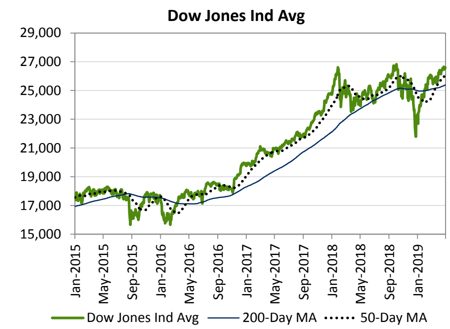
Christopher C. Cafley, MBA, VP, PM
Head of Structured Solutions & Alternative Investments

Charts of Interest

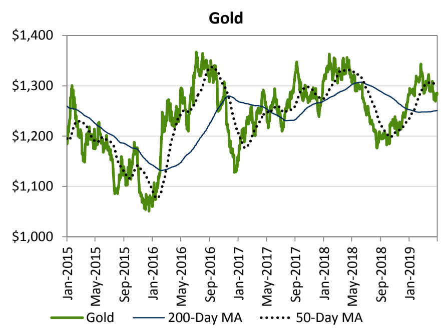
Markets

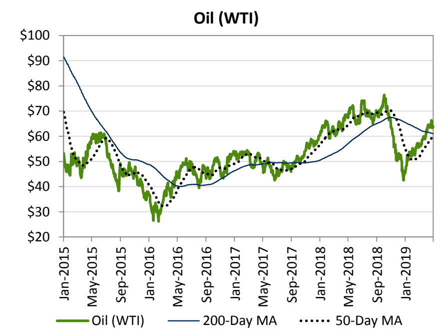


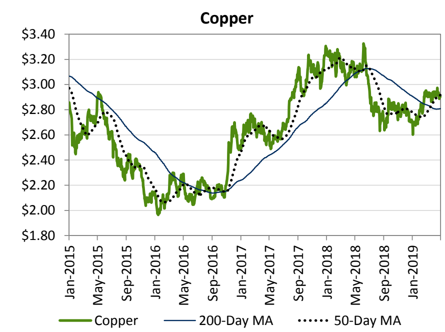




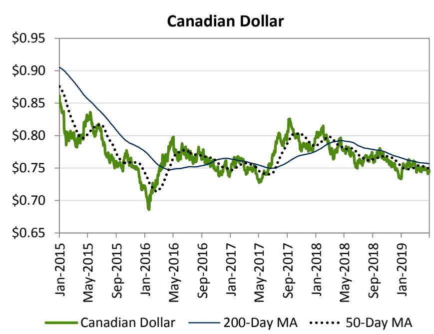
Commodities

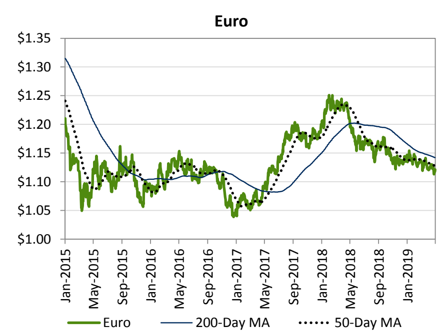


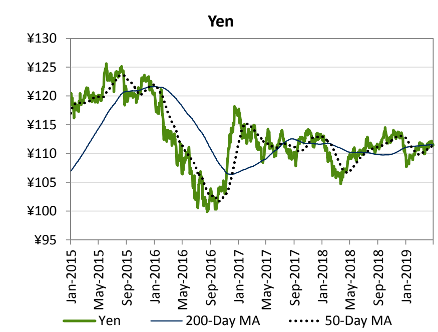




Currencies







Source: Bloomberg, Raymond James Ltd. Performance as at April 30, 2019.

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