# IRONIC – DON'T YOU THINK?

## Why Canadians should invest more globally, and everyone else should invest more in Canada

CEO Ali Dibadj and Portfolio Manager Aneet Chachra explain how Canadian and non-Canadian investors can both enhance their portfolio diversification by allocating more to each other's markets.

Canada is unique. It's the second-largest country (after Russia) by area, even as its population represents less than 0.5% of the world. But it's also the ninth-largest economy, accounting for about 2% of global gross domestic product (GDP) and 3.5% of global equity market capitalization. Moreover, Canada enjoys abundant natural resources including energy, metals, and water.

To foreign visitors, Canada often seems superficially similar to the United States culturally and geographically. Both countries are bounded by oceans, share major lakes, and are separated by the largest land border in the world.

Canada and the U.S. clearly have many commonalities. But they also have important differences, particularly in areas such as language, banking, politics, and healthcare.

The two countries have a close economic relationship. Unsurprisingly, Canada's largest trading partner is the United States. But surprisingly, the U.S.'s largest trading partner is also Canada, with the U.S. trading more with Canada than it does with countries such as China and Mexico.[1] Remarkably, both economies usually perform similarly: Exhibit 1 shows that their respective GDP growth rates have closely tracked each other historically.


**Ali Dibadj**
Chief Executive Officer

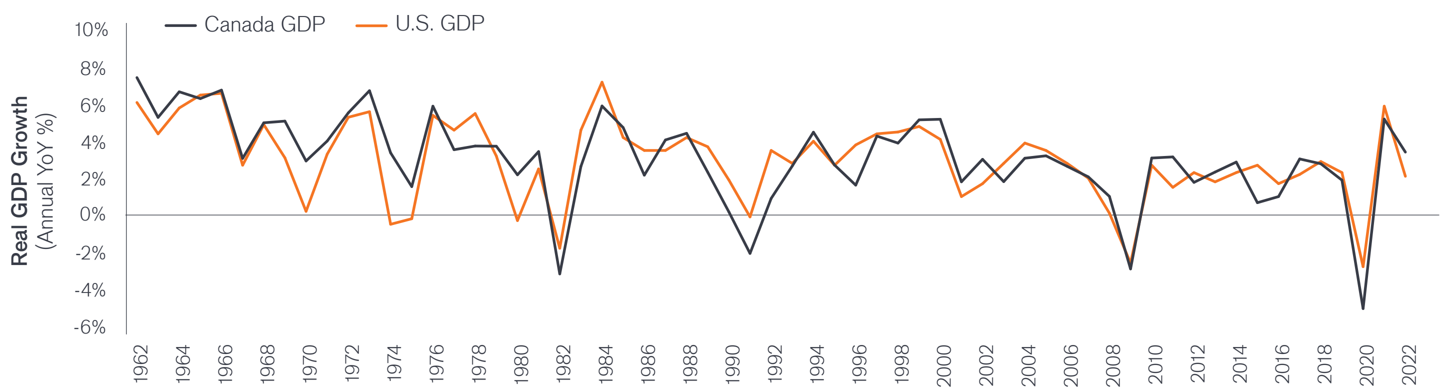


**Aneet Chachra**
Portfolio Manager


### Key takeaways

- Canadian and U.S. equity markets are quite different from a sector, style factor, and performance perspective despite the close economic ties between the two countries.
- The remarkable negative correlation between the Canadian dollar and global equities can provide a natural hedging benefit to Canadians investing abroad.
- Both Canadian and American investors could potentially improve their portfolio by allocating more to each other's markets.

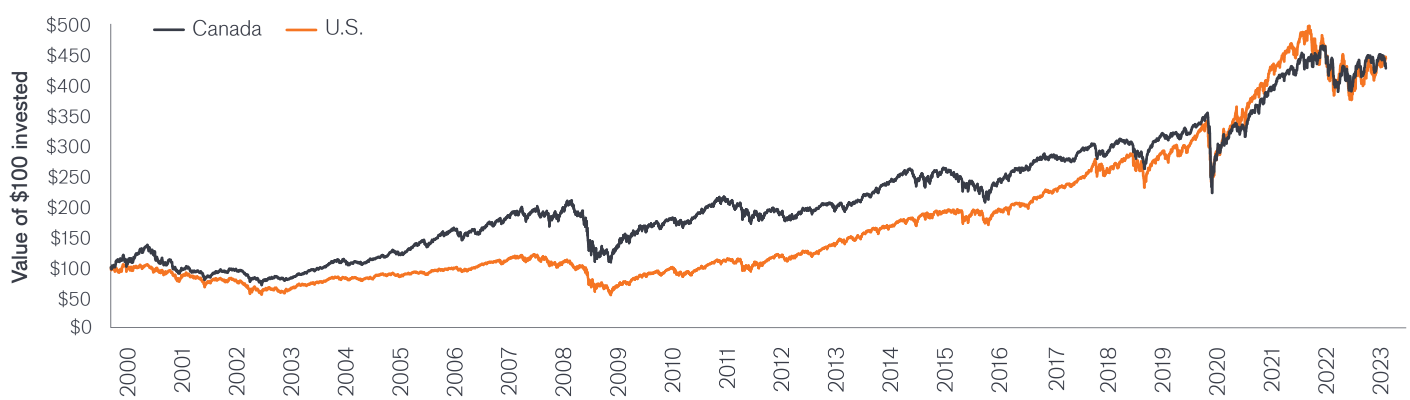
## Exhibit 1: Canada and U.S. GDP grows and contracts together




Source: Bloomberg, Janus Henderson Investors, January 1962 to December 2022.

Moving into markets, the benchmark Canadian stock index (S&P/TSX Composite) has performed in line with the U.S. S&P 500® Index since the start of this century, but with significant divergences along the way. For example, in Exhibit 2, you can see that Canadian stocks generally outperformed U.S. stocks from 2000-2010 but have underperformed since.

## Exhibit 2: Canada and U.S. stock index performance (including dividends)




Source: Bloomberg, Janus Henderson Investors, January 2000 to May 2023. **Past performance is no guarantee of future results.** Indexes used are the Canadian S&P/TSX Composite Index and S&P 500® Index.

Notably, the two markets are compositionally very different. The Canadian market has high weights in sectors such as banks, insurance, mining, oil and gas, transportation, and pipelines. Thus, the Canadian S&P/TSX Composite index has a value tilt with a higher dividend yield, and lower price-to-earnings and price-to-book ratios relative to global market averages.

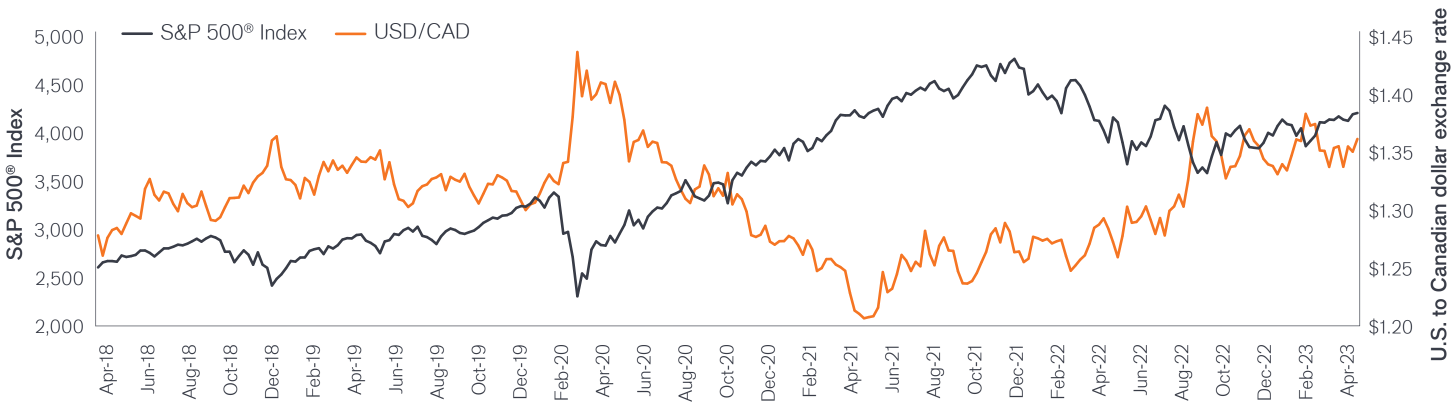
Conversely, the U.S. market has high weights in sectors such as software, internet, computers, semiconductors, pharmaceuticals, and healthcare products. This gives the U.S. S&P 500 Index a growth tilt relative to global market averages.

## A natural hedge

The Canadian dollar (CAD) plays a key role in the economic relationship between Canada and the world. Importantly, the CAD typically strengthens during periods of strong global growth and vice-versa. This is largely good for Canada as it provides counter-cyclical support to the economy. During downturns, the weaker currency makes its exports more price-competitive and attracts investment to Canada.

Interestingly, there is a visibly clear pattern between equity market and CAD price moves. For example, over the last five years, the U.S. dollar-to-CAD exchange rate (USD/CAD) looks like a mirror image of the U.S. S&P 500®. This illustrates that the U.S. dollar usually weakens when stocks go up and strengthens when stocks go down.

### Exhibit 3: U.S. stocks and USD/CAD often move in opposite directions




Source: Bloomberg, Janus Henderson Investors, April 2018 to May 2023. **Past performance is no guarantee of future results.**

This relationship is particularly beneficial to Canadians who expand into global assets as it can provide a natural hedge. For example, consider a Canadian investor who buys the S&P 500 Index and does not otherwise hedge the currency risk. When the index falls, the asset loss is partially cushioned (on average) by the currency gain holding U.S. dollars (in Canadian dollar terms). This typically reduces the volatility of the investor's returns.

Consequently, the historical Sharpe ratio of a Canadian investor holding the S&P 500 has been higher than the Sharpe ratio of a U.S. investor holding the same S&P 500 instrument.

While all investors should diversify, this exchange-rate relationship makes it especially attractive for Canadians to globally diversify their portfolios. Impressively, large Canadian pension plans have long recognized the need to hold a global market portfolio and broadly allocate accordingly.

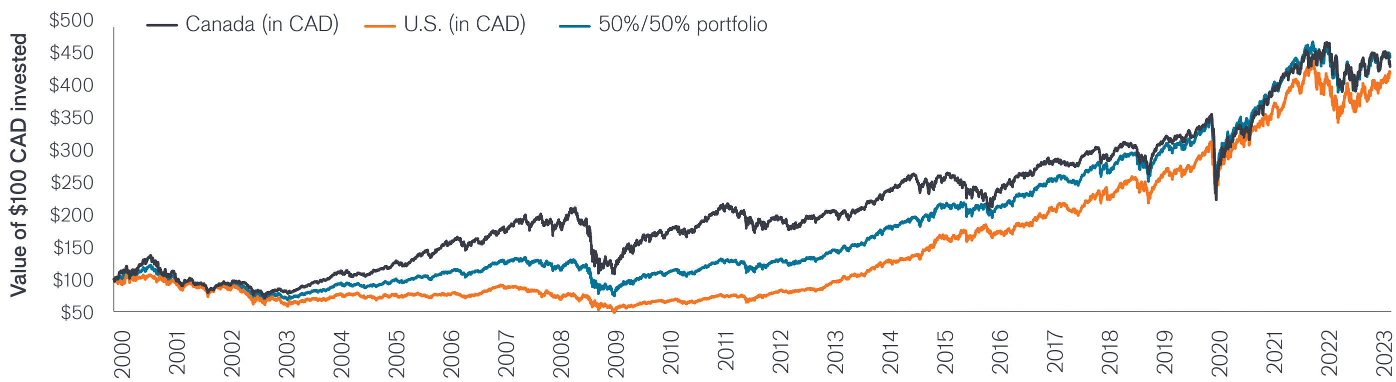
However, considerable home bias remains: Available data suggests that more than 50% of equities held in Canada are allocated to Canadian stocks (versus Canada's 3.5% weight in world markets).

Retail participants in particular are more likely to be heavily over-allocated domestically. And we understand why – Canada is a great country with strong institutions (full disclosure – both authors of this note are Canadian). Yet we still think many Canadians could improve their portfolios by investing more internationally, like their pensions already do.

## A more efficient portfolio

Let's illustrate with an example. Consider a Canadian investor with a Canadian dollar-denominated portfolio who allocates to a "half-and-half" blend of Canadian and U.S. stocks and rebalances annually. Notably, this simple blend had a modestly higher return AND lower volatility than either of the individual indexes.

### Exhibit 4: A simple Canada/U.S. stock index blend (for a Canadian dollar investor)




Source: Bloomberg, Janus Henderson Investors, January 2000 to May 2023. **Past performance is no guarantee of future results.** Hypothetical examples are for illustrative purposes only and do not represent the returns of any particular investment. Index performance does not reflect the expenses of managing a portfolio as an index is unmanaged and not available for direct investment. The performance of any index herein is not illustrative of the performance of any security.

Additionally, the portfolio helps balance factor exposure. Although both economies are closely linked, the compositional differences between the two stock markets are substantial. For example, the U.S. S&P 500 returned -18% last year, while the Canadian S&P/TSX composite index's total return of -6% was much better. The Canadian index benefitted from its higher weight to energy and lower weight to technology stocks than its U.S. counterpart.

But the opposite occurred in 2015, when oil prices dropped sharply and U.S. equities rose while Canadian equities fell. These examples show how global diversification might help mitigate unintended factor or currency bets. This is a basic two-market example; we think a broader mix of countries and diverse asset classes could further improve outcomes for Canadian investors.

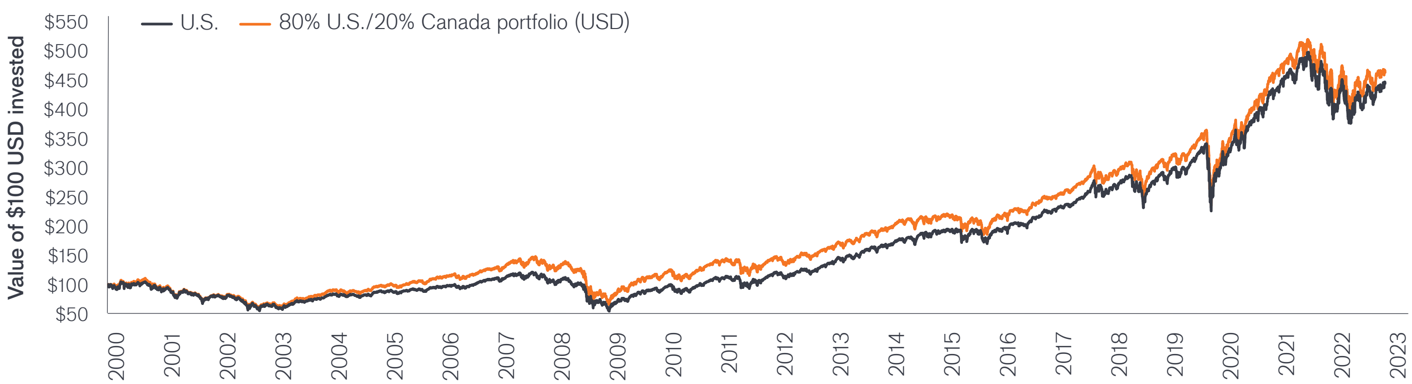
## And who would've thought?

We've focused so far on showing reasons why we believe Canadians can consider investing more globally, but the converse can be true as well – a global investor could potentially improve their portfolio by allocating more to Canada.

Consider an American with a U.S. dollar-denominated portfolio who buys Canadian stocks. Unfortunately, from their point of view, the observed relationship between equities and the U.S. dollar is broadly detrimental, as it raises volatility. For example, if global equities fall and the U.S. dollar strengthens, then the value of the American investor's international holdings drops due to both asset and currency factors. Instead of cushioning the loss, the typical currency move tends to enlarge it.

Nevertheless, increasing diversification can still be beneficial despite this volatility headwind. Let's evaluate a blend of 80% U.S. stocks and 20% Canadian stocks (no currency hedge) rebalanced annually from a U.S. investor perspective compared to a benchmark 100% U.S. stock portfolio.

### Exhibit 5: An 80% U.S./20% Canada stock index blend (for a U.S. dollar investor)




Source: Bloomberg, Janus Henderson Investors, January 2000 to May 2023. **Past performance is no guarantee of future results.** Hypothetical examples are for illustrative purposes only and do not represent the returns of any particular investment. Index performance does not reflect the expenses of managing a portfolio as an index is unmanaged and not available for direct investment. The performance of any index herein is not illustrative of the performance of any security.

The chart shows that, even for a U.S. investor, adding some Canadian stocks improved the return profile while total portfolio volatility was essentially unchanged. Americans also can potentially benefit from the sectoral diversification and value tilt that Canadian markets provide.

## It figures

For Canadians, there are multiple reasons to invest more globally: increase diversification, reduce home bias, balance style exposures, and incorporate a natural currency hedge. Additionally, Canadian investors can access assets and products that are otherwise unavailable in Canada.

Meanwhile, U.S. and other global investors should recognize the many favorable attributes of Canada and Canadian markets when determining their portfolio mix. Investing more in Canada could enhance their portfolio.

Accordingly, both Canadian and non-Canadian investors can be better off by allocating more to each other's markets.
**Isn't it ironic, don't you think?**

## About the authors

### Ali Dibadj

Chief Executive Officer

Ali Dibadj is Chief Executive Officer of Janus Henderson Investors and also serves as a member of the board of directors. In this role, Ali is responsible for the strategic direction and overall day-to-day management of the firm. He also leads the firm's Executive Committee. Prior to Janus Henderson, Ali was chief financial officer and head of strategy at AllianceBernstein (AB) from 2021. He held several roles with AB from 2006, including head of finance and strategy, portfolio manager for AB equities and senior analyst. Before AB, Ali spent almost a decade in management consulting, including with McKinsey & Company and Mercer. He also worked for law firm Skadden, Arps. Ali sits on the Board of Sysco Corporation.

Ali has a bachelor of science degree in engineering sciences with a specialisation in electrical engineering, from Harvard College, graduating magna cum laude and a juris doctorate with a focus on law and business, from Harvard Law School, graduating cum laude. He has 26 years of financial industry experience.

### Aneet Chachra

Portfolio Manager

Aneet Chachra is a Portfolio Manager at Janus Henderson Investors on the Multi Strategy and Global Diversified Risk Premia strategies. Prior to joining Henderson in 2012, Aneet was an equity analyst at Citigroup. Before Citigroup, he was a strategist at Outpost Investment Group, where he generated trade ideas, researched thematic issues and published investment commentary. Aneet also developed quantitative trading strategies and portfolio analytics at JWM Partners. He began his career in 2000 at Morgan Stanley developing tools for interest rate derivatives and corporate bonds. Aneet's research work has been quoted in numerous financial publications.

Aneet holds a BASc degree in engineering and a BA degree in economics from the University of Waterloo in Canada. He also holds the Chartered Financial Analyst designation and the Investment Management Certificate. He has 23 years of financial industry experience.

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[1] List of the largest trading partners of the United States – Wikipedia.

**Equity securities are subject to risks including market risk. Returns will fluctuate in response to issuer, political and economic developments.**

**Concentrated investments** in a single sector, industry or region will be more susceptible to factors affecting that group and may be more volatile than less concentrated investments or the market as a whole.

**Foreign securities** are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

**Diversification** neither assures a profit nor eliminates the risk of experiencing investment losses.

**Dividend Yield** is the weighted average dividend yield of the securities in the portfolio (including cash). The number is not intended to demonstrate income earned or distributions made by the portfolio.

**Index investing** is a passive investment strategy that seeks to replicate the returns of a benchmark index.

**Price-to-Earnings (P/E) Ratio** measures share price compared to earnings per share for a stock or stocks in a portfolio.

**Price-to-Book (P/B) Ratio** measures share price compared to book value per share for a stock or stocks in a portfolio.

**Sharpe Ratio** measures risk-adjusted performance using excess returns versus the "risk-free" rate and the volatility of those returns. A higher ratio means better return per unit of risk.

**S&P 500® Index** reflects U.S. large-cap equity performance and represents broad U.S. equity market performance.

**The Canadian S&P/TSX Composite Index** is a capitalization-weighted equity index that tracks the performance of the largest companies listed on Canada's primary stock exchange, the Toronto Stock Exchange (TSX). It is the equivalent of the S&P 500 index in the United States, and as such is closely monitored by Canadian investors.

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