International diversification makes sense, but the timing and specifics are crucial

IAN MCGUGAN
PUBLISHED JULY 8, 2023

If you're a typical Canadian investor, you prefer home cooking. Most of the stocks in your portfolio are Canadian.

And why not?

You know more about Canadian companies than foreign ones. Plus, you don't have to worry about currency fluctuations when you collect dividends in loonies and spend those loonies in Canada. Add in tax advantages and there would appear to be solid reasons for investors to stay close to home.

Yet practically no one in the investing industry agrees with that cozy stand. In recent months, a stream of research papers has made the case for why most investors need more international diversification.

Vanguard Investments Canada just published a report that argues Canadian investors should ideally have 30 per cent Canadian stocks and 70 per cent foreign stocks in their portfolios.

Similarly, the American-British fund company Janus Henderson concludes in a new paper that both Canadian and U.S. investors can benefit from holding portfolios that span both countries.

Meanwhile, renowned quantitative researcher Cliff Asness and his team at AQR Capital Management declare in the June issue of The Journal of Portfolio Management that international diversification is "still not crazy after all these years."

What is behind this sudden outpouring of love for international diversification? It may owe something to the fact that going global works in theory, but has flopped in practice over the past three decades.

U.S. stocks have beaten all rivals over that period and delivered particularly outstanding returns over the past decade. That has made many people around the globe wonder if holding anything other than U.S. stocks is worth the trouble.

For Canadian investors, the question of international diversification is particularly tricky.

The Canadian stock market makes up only a sliver – about 3.4 per cent – of global stock markets. It is heavily tilted toward just two areas – banks and energy companies.

In theory, therefore, investors here should be able to benefit by venturing out into the world, especially in to the much bigger, much more diversified U.S. market.

However, the problem right now is that the U.S. market is considerably more expensive than its global counterparts. It trades for roughly 20 times forward earnings compared with 13 times for its Canadian counterpart.

If Canadian investors diversify into U.S. stocks today, they are doing the opposite of what a good bargain hunter should do. They are tilting toward a more expensive asset.

So how should you approach international diversification? Here are three things to keep in mind.

It's good but not perfect

International diversification won't save you in the short term. When markets crash, they do so together. Remember the start of the pandemic? Or the global financial crisis? Everything fell simultaneously.

What global diversification can do is to protect you from long dry spells in your local market. "We find international diversification does a pretty great job of protecting investors over the long term," Mr. Asness and his AQR team write.

For Canadian investors, this is an important benefit given the narrowness of the local stock market. Recall that Canadian stocks flatlined for more a decade after the financial crisis of 2008. The S&P/TSX Composite was trading at the same level in January, 2019, as it was in June, 2008.

The simplest way to protect yourself from such bleak patches is to hold a significant amount of international stocks. The tricky question is where those stocks should be.

The case for America

John Bogle, the father of index investing, famously said that U.S. investors had no need to venture beyond the United States. This wasn't just chauvinism at play.

The U.S. benefits from a huge internal market, the world's biggest stock market and deep pools of capital. This may give it a sustainable structural advantage. From 1900 through 2022, U.S. stocks beat non-U.S. stocks by about two percentage points a year, according to Credit Suisse researchers.

The past decade has been particularly stellar for U.S. stocks. They have beaten their Canadian rivals by roughly six percentage points a year.

The case against America

The outperformance of U.S. stocks is impressive. However, it may not be quite as imposing as it appears.

Mr. Asness and his AQR team note that U.S. and non-U.S. stocks grew their earnings and other fundamentals at similar paces over the past three decades. The only reason U.S. stocks performed significantly better was because investors were willing to pay more and more for a dollar of U.S. earnings.

To put that another way, the U.S. outperformance "came overwhelmingly from the U.S. market simply getting more expensive," they write.

This trend is not likely to repeat itself over the next 30 years, they argue. At some point, investors will balk at the valuation difference. If anything, there could be a snapback, with non-U.S. markets finally beginning to offer better returns than U.S. ones.

Bottom line

International diversification makes sense. The problem is figuring out the timing and the specifics.

Vanguard estimates that Canadian investors currently devote about 48 per cent of their stock holdings to foreign equities. It argues that 70 per cent would be better.

Maybe so. I'm not so convinced, though, that Canadian investors have to rush to meet that goal.

Given the lush prices on U.S. equities, I'd be inclined to bide my time, until the valuation gap between the markets has narrowed.