A Coke with your Free Lunch

It has been said that the only free lunch in investing is diversification. There are many ways to look at diversification, but the investment industry has not done a good job keeping pace with the dynamic changes in public markets. First, let's get bonds out of the way so we can focus on equities. Bonds are a hedge against equities, traditionally providing a reasonable yield and downside protection when equities go negative, which happens every two to three years per decade. With yields so low do you need bonds in your portfolio? Probably – see reason two above.

Investors with a plan, otherwise known as an Investment Policy Statement (IPS), generally break out how much of their portfolio will be invested in bonds, equities, real estate, and other assets. Equities are further categorized by allocations to Canada, US, International and perhaps even Emerging Markets. The problem with this is that leading companies today are so globally diversified that slotting them into a country or region does not make much sense anymore. Coca-Cola has about 60% of its revenues coming from outside of the US but the investment industry still consider it a US equity! This is a "Classic" example.

Has the time spent developing and staying within your IPS guidelines become irrelevant? Maybe not if we look at risk and diversification a different way. Looking at diversification initially at the sector level and then translating that to the regional level will lead to better diversification. This approach is especially useful for Canadian investors as 70% of the S&P/TSX is composed of three sectors - Financials, Energy and Materials. The composition of the S&P/TSX represents the productive output of Canada – although somewhat imperfect.

Companies are global, industries are emerging, and commerce is without borders. If we want to create a global portfolio to better capture investment opportunities and provide diversification, perhaps we should look at the sector composition of the MSCI World Index as a start. The MSCI Word Index has only 36% allocated to the Financial, Energy and Material sectors illustrating its breadth in other sectors. Robust sectors like Information Technology and Healthcare have the depth of global leaders like Taiwan Semiconductor, Apple, Johnson & Johnson, and Merck to consider.

So if we are creating a diversified portfolio that represents global opportunities across broad sectors but still working with regional allocations, how much do we allocate to Canada, to the US and to International stocks? A sharpened pencil (or a simple model) will tell you about 20% to Canada and the remainder equally allocated to US and International stocks. Let's appreciate that there are certain tax advantages and currency risks that would raise the amount allocated to Canadian stocks. A simple equal allocation to Canada, US, and International markets generated solid Canadian dollar returns inside of the last 15 years for investors and that is on the back of diversification – I recommend a Coke with your free lunch.