Diversification is Good for Your Wealth

Equity Markets

Equity markets posted further gains over the last three months of the year, concluding a very profitable year for equity investors across all major economies. In Canada, markets rose 4.5% in Q4 despite ongoing weakness in the heavily-weighted Energy sector, powered by broad-based increases across the other sectors including a strong performance from major domestic Financial corporations. The American market continued to surge, rising 6.6% in U.S. dollar terms as gains across numerous industries were accompanied by optimism surrounding a substantial reduction to the corporate tax regime. European and Asian markets rallied 4.2% in U.S. dollars, helped by improved economic data from Japan and continental Europe.

These international returns were supplemented by a slightly weaker domestic currency in Q4 (the loonie softened by 0.8% versus the U.S. dollar in the quarter), however, the depreciation over the final three months of the year did little to unwind the general firming seen over the previous nine months — the Canadian dollar ended the year up 6.9% against the U.S. dollar. This overall currency appreciation in 2017 had the impact of dampening the full-year Canadian dollar returns for the international markets, though they still outperformed the 9.1% total return in the domestic market — the S&P 500 returned 13.6% when translated back into loonies while the MSCI EAFE index was up 16.6% and Emerging Market equities posted an outsized 28.0% return for the year.

Fixed Income Markets

After hiking the overnight policy rate in consecutive meetings in Q3 and leading the market to anticipate that further hikes may be in the offing, the Bank of Canada tapped the brake in the final three months of the year. The BOC adopted a much more cautious tone against the heightened uncertainties clouding the outlook (most notably related to trade policy with the U.S.). The dataflow has been persistently solid, however, increasing the odds of a rate hike coming sooner rather than later (a move in Q1 is very much on the table).

The Canadian bond market's yield curve continued to flatten in the final three months of 2017 — the yield on the benchmark 2-year Government of Canada note rose from 1.52% yield on September 30th to 1.69% at the end of December and benchmark 5-year yields were offered at 1.86%, up from 1.75% to start the period; 10-year Canada bond yields, in contrast, fell by the close of the quarter to 2.04% from 2.10% while yields on the long bond plunged to 2.1% from 2.47% at the end of Q3.

The positive economic backdrop led policymakers stateside to continue on with their policy normalization process. The U.S. Federal Reserve (Fed) began to taper the reinvestment of the principal of maturity securities on its balance sheet in October (this was announced in September) and followed-through with their third rate hike of the year in December, bringing the target range for the fed funds rate up to 1¼% to 1½%.

Despite the indications that the Fed will continue its gradual unwinding of crisis-era monetary stimulus for the foreseeable future, the market evidently is not fully convinced. The long-end of the Treasury has barely budged from the ranges that prevailed over the second half of 2017 while the long-bond actually rallied through Q4. The front-end of the curve has sold off, however, leading to a flattening of the yield curve — the two-year Treasury yield sat at 1.88% at the close of December, up from 1.48% at the end of Q3 while the 10-year yield posted a more modest rise to 2.41% versus 2.33%; the 30-year yield actually fell notably, down to 2.74% by quarter-end after starting the quarter at 2.86%.

Commentary

Recently, Norway's Government Pension Fund (GPF), the world's largest sovereign wealth fund with over $1 trillion in assets, announced its intention to divest all of its oil & gas holdings from its investment portfolio.

Now, while it may seem odd for an investor of that magnitude to exclude any segment of the stock market from their investable universe (the Energy sector accounts for 6% of global investable market by market capitalization), this is actually prudent with respect to the risk management of their investment portfolio.

The GPF was established in 1990 to invest profits earned by the Norwegian government in relation to its oil reserves — the revenues are generated by corporate taxes, payments for licenses to explore for oil and flows from the partially state-owned oil company, Statoil (the Fund was initially named the Petroleum Fund of Norway; it was renamed in 2006 and its still commonly known as the Oil Fund).

What this means is the GPF is highly exposed to the Energy sector outside its investment portfolios — the flow of money into the Fund is dependent on the performance of the oil & gas sector. As a result of this, maintaining even a market-weight allocation in oil & gas stocks in their financial portfolio actually leaves the Fund over levered to oil and gas, which in turn means that their overall exposures are out of balance vis-à-vis their benchmark.

The whole purpose of diversification is to spread the risk exposures so that when one holding experiences a downswing, it is offset by gains made elsewhere. And while the focus of diversification is typically investment portfolios — owning both stocks and bonds across industry sectors and geographies — it is also prudent to diversify away from the source of your income & wealth as well.

The financial position of GPF is already inseparably tied to the fortunes of the oil & gas sector; it is easy to argue that it does not need to be even more so through its investment holdings.

Indeed, in explaining their decision the GPF stated:

> *It might be beneficial for an investor that already has substantial oil price exposure outside their financial portfolio, not to add to this exposure by investing in oil and gas stocks in their financial portfolio.*

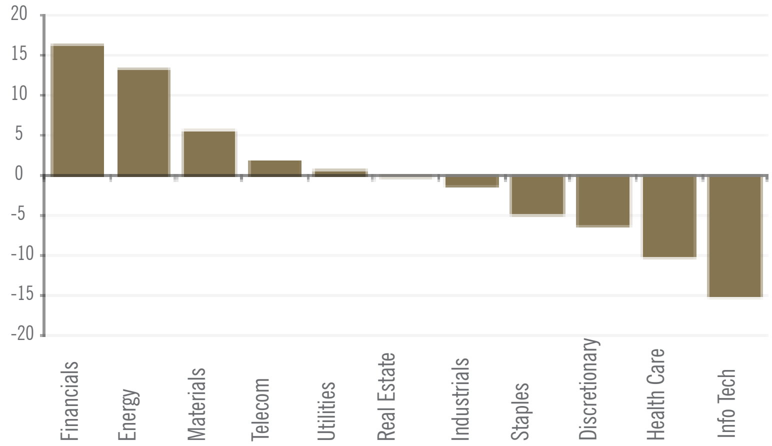
This type of reasoning should also extend to individual investors as well — if you are a property developer, you should probably reduce the exposure to real estate in your personal investments; mining executives who see a substantial portion of their incomes paid in the form of company stock would likely find it beneficial to be underweight the benchmark in the Materials sector in their financial portfolios to avoid over-concentration.

While the likes of Warren Buffett preach the benefits of investing in what you know, with respect to risk exposures, it can be the case that avoiding what you don't know can be bad for your wealth.

More broadly, Canadian investors who focus their holdings strictly on the domestic market may do well to take note too. Canada's stock market accounts for just 3% of global equity market capitalization and is heavily concentrated in just three sectors — Financials, Energy and Materials; those three industries alone represent half of the market value of the TSX. In other words, just passively buying the domestic stock market index leaves you with a very concentrated portfolio that is significantly underweight the global benchmark for some major sectors — most notably Information Technology and Health Care.

Weight Mismanagement

S&P/TSX Composite Index Sector Weights Relative to MSCI All-Country World Index (percentage points)



Source: Bloomberg, Guardian Capital

For Canadian investors to stick just to the areas where they have familiarity because of the local market — namely natural resources and banks — leaves their investments highly concentrated and extremely exposed to cyclical market forces. That means that these investors are doubly impacted by a downturn in the Canadian economy, since it adversely impacts their own incomes as well as their investment portfolios.

Expanding investment into other markets outside of Canada allows for a better balance of risk exposures that can complement domestic holdings and helps to diversify the risks to your own income flows. Diversification is good for your wealth.

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