LEITH WHEELER INVESTMENT OUTLOOK

Leith Wheeler
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The Implications of Unrestricted Foreign Content

As announced in the 2005 Budget, Canadian investors will no longer need to cap their registered holdings of foreign securities at 30%. In this *Outlook*, we review what this means for our clients' portfolios and whether we expect significant changes on the part of Canadian investors.

Arguments in favour of investing in non-Canadian assets

Let's begin by reviewing the rationale for investing outside of Canada - these are the classic arguments raised by those who opposed any restriction on foreign content:

1. Canada represents a small percentage of the world's markets (around 2%), so for diversification purposes, having all one's eggs in the Canadian basket is not a good idea over the long term.
2. From an industry perspective, the Canadian market has low exposure in some areas, for example Health Care stocks. Canadian markets are more concentrated in sectors like Financials and Energy stocks. The global markets increase the "opportunities" for investors.
3. Exposure to foreign currencies is a part of the diversification argument, in that this exposure is yet another different source of "return" (although recently negative, since the Canadian dollar has been strong).

There is no question that global equities are a useful part of most client portfolios. But are these valid arguments for ***increasing*** the amount that should be invested in non-Canadian assets, or are they simply a re-hash of the justification for ***some*** exposure to foreign assets? In other words, is the 30% limit sufficient in most cases?

Some of the comments we have read in the press recently suggest that Canadians have suffered a penalty in returns due to the 30% foreign content limit. We analyzed equity market data going back 35 years to see if this has been the case. While the results can be influenced by the period chosen, particularly the start and end dates, 35 years is a significantly long period and captures most of the investing lifetime of those reading this article. To explore this in more detail, we looked at:

* The impact on return and risk, as foreign content is increased from 0% to 30%, and from 30% to 100%
* To what extent a weak Canadian dollar has boosted the returns from foreign equities

Over the full 35 year period, the evidence does not support the notion that Canadian investors have suffered particularly from a restriction on foreign content. The Canadian equity index returned 10% per annum over the full period, while the Global equity index returned 10.1% per annum. This small return advantage is comprised entirely from currency gains, which were worth almost 1.4% per annum...a significant proportion of the total return from the foreign markets. Without these currency gains, foreign equities lagged Canadian equities.

We would note that foreign equity portfolios can often carry higher fees than Canadian portfolios, which would have eliminated this small return advantage of 0.1%.

From a diversification standpoint, foreign equities served Canadian investors well, even if the return advantage was minimal. Risk was reduced at the overall portfolio level by adding foreign equities to a Canadian equity portfolio. (We have measured risk for this purpose by measuring how much the returns fluctuated, interpreting more stable returns as being less risky.)

Let's dig deeper into the benefits of risk reduction: as one added foreign equities into the mix, the initial reduction in risk was quite sharp, ***but the pace of risk reduction slowed significantly as more foreign equities were added.*** As foreign equities approached ***50% of the total equity portfolio***, most of the risk reduction benefits had already been achieved. Further risk reduction benefits tended to be quite

Leith Wheeler Investment Counsel Ltd. is an employee owned firm providing portfolio management services for individuals, pensions and foundations.

Leith Wheeler
Suite 1500, 400 Burrard Street
Vancouver, B.C. V6C 3A6

Tel 604.683.3391
Fax 604.683.0323
info@leithwheeler.com
www.leithwheeler.com

marginal. To us, this is evidence of the *law of diminishing marginal returns* at work. We tested several long time periods and found that over 80% of the total possible reduction in risk typically occurred when foreign equities reached 50% of the equity portfolio.

For a typical balanced portfolio, with 60% invested in equities and 40% in bonds, half of the equity portfolio would amount to about 30% of the total fund...exactly the level at which Canadian investors have been restricted.

Arguments in favour of maintaining a significant exposure to domestic assets

Evidence from surveys around the world suggest that investors favour their home markets. This "home country bias" is probably due in part to the greater familiarity with domestic markets, and is largely evident even in countries that have not had restrictions on foreign content. The average pension plan in Australia, for example, holds more domestic equities than global equities, and far more domestic bonds than global bonds. Australia does not have any restrictions on foreign content, and has an economy and stock market that is smaller than Canada's.

Besides the familiarity point, domestic investing may also be popular due to lower costs, or due to the attractive track records of domestic active managers. This would be the case in Canada, since our domestic market has been easier for the median Canadian manager to beat, on an "after fee" basis. Managers in the U.S. for example, have had a more difficult time beating the U.S. index, after fees.

Another argument for having a large weighting in domestic assets is due to currency risk. Over the shorter and medium term, currency movements have been volatile and have significantly affected global returns when expressed in "home country" currencies. This is of concern to anyone whose livelihood is in the home country - for a Canadian investor retiring in Canada, or for a Canadian pension plan or endowment fund with Canadian dollar obligations, only so much currency risk can be tolerated. While this risk can be hedged, hedging is not a simple matter. Most companies with global revenues have their own currency hedging program, which can be negated or compromised by another hedge on top of that. Hedging programs are also not as available to the retail investor, and even the largest pension plans have not developed any kind of consensus as to whether to use currency hedging, in which markets to use it, and to what extent.

We would also note that the dividends paid on Canadian stocks have a preferential tax treatment compared to foreign dividends, for taxable Canadian investors.

Our view as an active equity manager

There are some generalizations you may hear in the Canadian market that are not applicable to us - for example, "now we can sell Nortel and buy Cisco". This does not affect Leith Wheeler, since we are not benchmark huggers that hold a stock like Nortel if we are negative on the company. Some managers will express their negative views by holding a "less than index" weight in Nortel. Our current "less than index" weight in Nortel is a zero weight, which reflects our current views. Our clients hire us to build portfolios of our best ideas and research, not ones that track the broad index.

Our Canadian portfolio is well diversified by number of companies and by industry exposure. It remains the core holding for our clients whose livelihood is in Canada. Our U.S. and EAFE portfolios, managed by Sprucegrove Investment Management, have delivered results that are in the top of their peer group, and have worked as a complement alongside our Canadian equity and bond portfolios.

In Summary

While adding foreign securities to a portfolio is a very good diversifier, most of the long-term benefits in a typical balanced fund have already occurred at current levels of foreign content usage. The additional risk of foreign currency exposure brought by much higher levels of foreign assets can be costly. We don't expect Canadian investors to buck the common trend and abandon their home market, nor do we see any reason for our clients to do so.

Contributing writer:
Perry Teperson, CFA, F.C.I.A.
Fixed Income Analyst

Editor:
Jon Palfrey, CFA
Vice President