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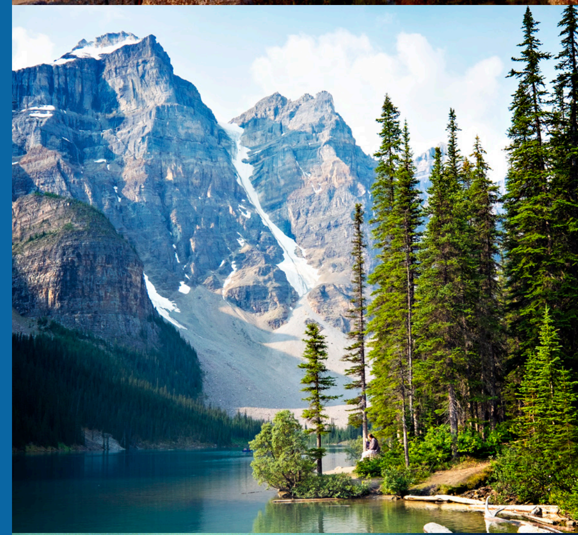


Home country bias: How much Canada should Canadian investors own?

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The termination of Canada's foreign property rule in 2005 set in motion a decades-long recalibration of Canadian retirement portfolios as investors shifted investments from Canadian to global exposures. Where Canadian investors were once restricted, they've been spurred on to draw down their exposure to Canadian assets, in part due to strong U.S. investment performance, a volatile interest rate environment and acute macroeconomic headwinds faced by the Canadian economy. And far beyond that, Canadian exposure in retirement portfolios have been drawn down because of the long-standing argument that Canadian markets are too concentrated.

If the posture of market participants is correct, enhancing and diversifying the drivers of portfolio risk should bolster risk-adjusted returns. However, one's frame of reference is critical, and our analysis suggests that there are limits to the degree to which Canadian investors should "sell Canada" in their strategic allocations. Multi-asset investors in Canada, especially those managing asset-liability exercises, enjoy differentiated payoffs compared to global peers.

KEY TAKEAWAYS

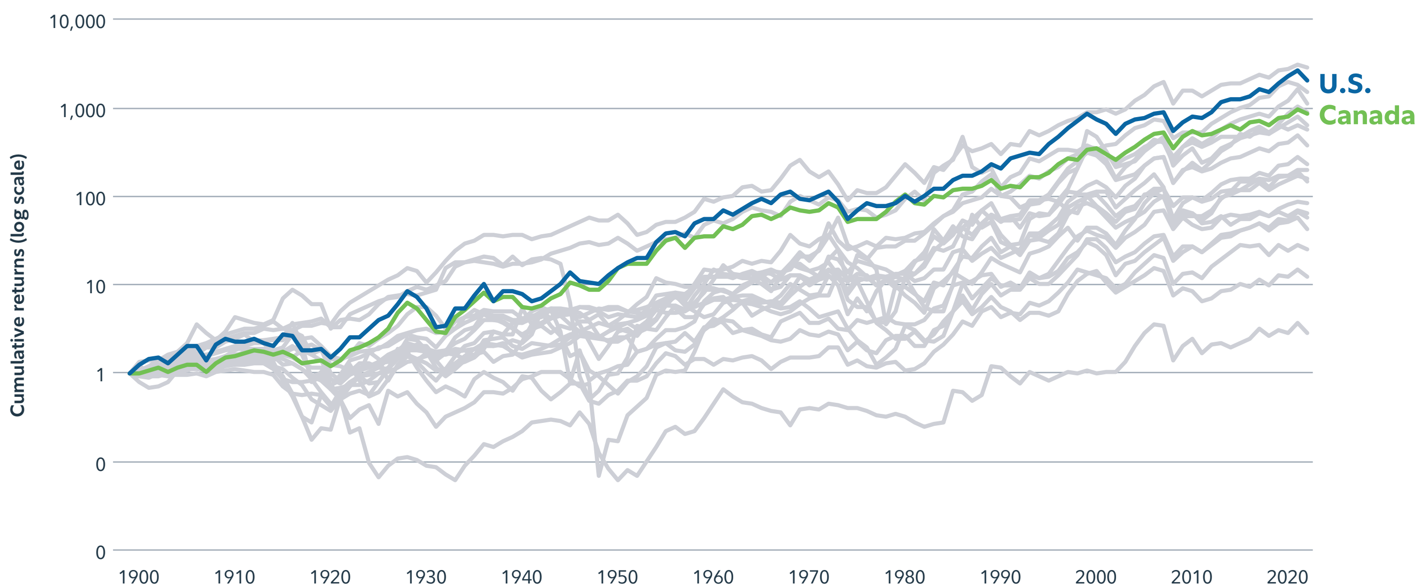
- The makeup of Canadian equities offers distinct risk-and-return attributes relative to global equity peers, producing favourable diversification in specific market environments.
- Historically, the Canadian dollar (CAD) has exhibited pro-cyclical risk and return properties. This dynamic motivates a differentiated approach to portfolio construction.
- Canadian target-date investors benefit from different levels of Canadian exposure in their portfolios as their lifecycle evolves.
- Canadian investors with CAD-denominated retirement savings goals should consider allocating a larger portion of their portfolio to Canadian investments.

What Canadian equities bring to the portfolio

The long-term history of Canadian equities typically surprises investors. While it is not grabbing the same headlines as Japanese equities did during the 60's, 70's and 80's, or equalling the last two decades of dominant outperformance we've seen from U.S. equities, Canadian equities have long been a compelling market that has generated strong investment outcomes (Exhibit 1).

Exhibit 1: Canadian equities have earned their place as a top-performing market.

The long-term study of global history helps to inform our expectations of investment returns.



Source: DMS Database and Fidelity Investments. As at December 2022.

A common push-back we hear among institutional investors, both Canadian and global, allocating abroad is that the domestic opportunity set is too concentrated, particularly among financial, material and energy names: combined, they represent about 60% of the MSCI Canada Index. By comparison, the same sectors make up roughly 25% of the MSCI ACWI.

There are certainly fewer companies in the Canadian market, naturally leading to greater concentration. However, the Canadian stock market is largely comprised of high-quality businesses with increasingly diversified global revenue streams. When we conduct a look-through credit analysis of the companies in the Canadian index using a Bloomberg composite credit rating, the resulting aggregate index rating is A+.[1] This is consistent with what we see in the U.S., which many regard as one of the highest-quality markets today.

Sector composition is one of the compelling properties we believe supports the investment thesis for a modest home-country bias in Canadians' portfolios. The Canadian market offers exposure to sectors that have seen declining weights globally, while offering less exposure to other sectors that have experienced commensurate increases, such as information technology. The investment result is that during periods of inflationary stress, we find Canadian equities have demonstrated unique risk-and-return characteristics relative to global developed market peers.

1 Not all companies included in the Canadian or U.S. indexes issue rated debt. This aggregate credit rating is built from issuers that have rated debt. Bloomberg composite rating looks across rating agencies, with the spectrum of potential ratings ranging from AAA+ to CCC-, as at December 2024.

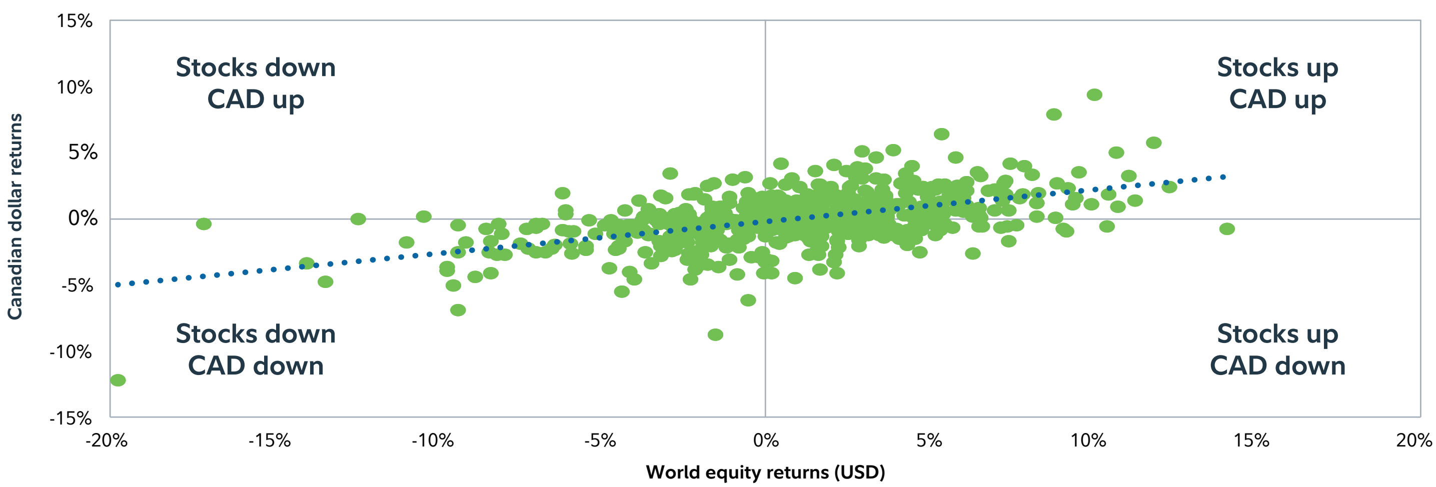
Procyclical local currency offers distinct tradeoffs.

"Procyclicality" describes an investment's positive sensitivity to economic growth. An investment that exhibits procyclical tendencies typically performs favourably during periods of good economic growth. Conversely, a countercyclical investment tends to perform more favourably during periods of below-average or even negative growth.

Canada is an export-driven economy in which nearly a third of GDP is generated by selling goods and services abroad.[2] In contrast, the U.S. has generated around 12% of its GDP from this source over the same period.[3] Exhibit 2 demonstrates this procyclical connection, using data that extends back to 1970, and shows the positive relationship between global equity returns and the Canadian dollar (CAD).

Exhibit 2: The Canadian dollar has exhibited procyclical tendencies through history.

Fifty-year relationship between the Canadian dollar and global equities



Source: Bloomberg and Fidelity Investments. Data from 1975 to 2024.

Focusing on the "stocks down, CAD down" quadrant, we can start to unpack this relationship and the benefits that accrue to Canadian investors. During periods of market decline, and specifically when market participants are facing uncertain growth prospects, there is a "flight to quality" as investors seek out "safer" investments. The byproduct of these flows is that historically we observe select global currencies (e.g., the pound, the euro, the yen and the U.S. dollar) appreciate relative to the Canadian dollar. This currency movement offers an additional layer of diversification and has produced less significant market drawdowns for investors who own un-hedged non-Canadian investments. This dynamic is clearly outlined in the table below, which evaluates drawdowns that exceed 10% for the MSCI All Country World Index (ACWI) since the global financial crisis, comparing Canadian and U.S. dollar investment returns. In every instance, depreciation of the CAD was advantageous relative to investors who have a "safe haven" domestic currency.

DRAWDOWN START	DRAWDOWN END	MSCI ACWI (CAD)	MSCI ACWI (USD)	DIFFERENCE
Feb 2007	Mar 2009	-47.5%	-52.1%	-4.6%
Aug 2015	Sep 2015	-10.1%	-11.8%	-1.7%
Dec 2015	Feb 2016	-11.7%	-12.5%	-0.8%
Sep 2018	Dec 2018	-13.4%	-16.8%	-3.3%
Feb 2020	Mar 2020	-27.3%	-33.7%	-6.4%
Dec 2021	Jun 2022	-21.0%	-21.8%	-0.9%

Source: Bloomberg and Fidelity Investments. January 2007 to December 2024.

2 World Bank national accounts data and OECD National Accounts data files, as at December 2023.

3 World Bank national accounts data and OECD National Accounts data files, as at December 2023.

The natural impulse is to question if *any* Canadian exposure is warranted. If investors can get equity returns with some additional defensive properties, why not invest entirely in global (ex Canada) securities? Movements in the Canadian dollar cut both ways, as demonstrated in the "stocks up, CAD up" quadrant of Exhibit 2. During periods of market growth, the CAD has a bias towards appreciating. This has the same influence of reducing the overall return of investments abroad. Allocating a larger proportion of one's global investment portfolio to Canadian-domiciled investments helps minimize the influence that fluctuations in the CAD can have on long-term expected risk and return.

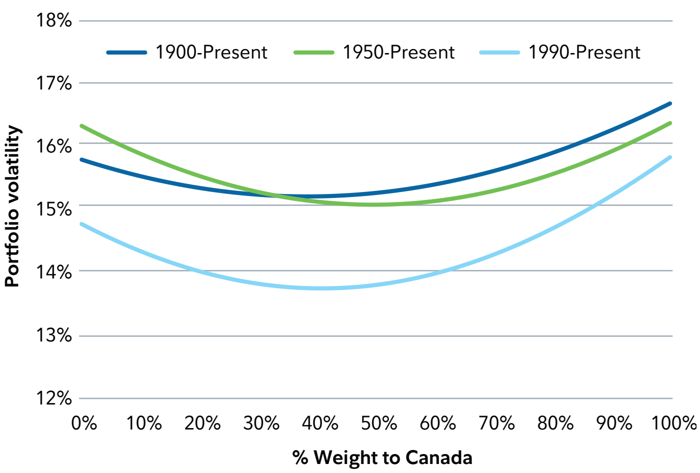
While CAD procyclicality has been a durable and effective diversification tool for Canadian investors in the long run, there have been occurrences where this relationship has flipped: global equity returns were amplified, positively or negatively (the stocks down, CAD up, and stocks up, CAD down, quadrants of Exhibit 2).

In our strategic research process, we aim to understand the relationships between investments and how they react in various market environments. We believe this is a more thoughtful approach to portfolio construction, and embeds a recognition that market relationships are bound to evolve through time. In Exhibits 3 and 4, we present some of our findings, pulling together the unique properties of the Canadian stock market and currency into a broader portfolio analysis.

The period we chose to observe influences the level of risk and return, but the dispersion of minimum volatility portfolios remains fairly consistent, at around 30–45%. On the margin, these weights lead to reduced returns; however, we believe the enhanced diversification more than compensates investors. Given the robustness of emerging market returns, we have excluded them from these illustrations. Our research indicates that both Canadian and emerging markets share export-oriented GDP sensitivities, but local factors provide diversification and distinct exposure for foreign investors. The inclusion of emerging markets in a Canadian investors' opportunity set would reduce the Canadian weight on the margin (approximately 5–10%).

Exhibit 3: Minimum-variance portfolios favours a Canadian home country bias.

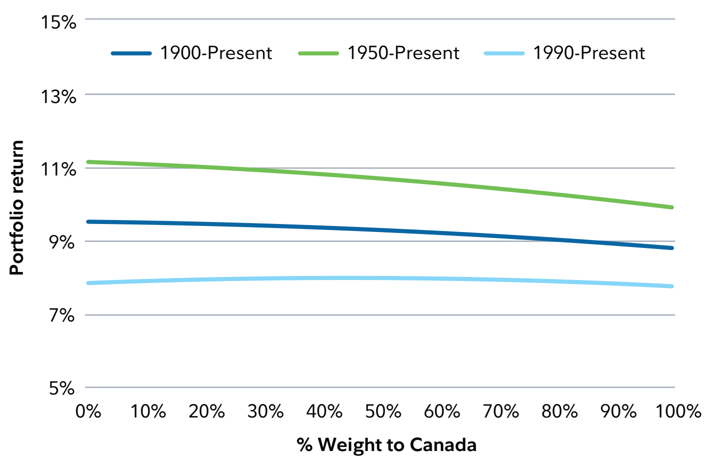
Increasing Canadian exposure may reduce portfolio volatility, to a certain point.



Source: DMS Database and Fidelity Investments, Monthly data from 1900 to 2024 as at December 2024.

Exhibit 4: Recent history favours increased Canadian equity exposure.

Increasing Canadian exposure may reduce total investment returns on the margin.



Source: DMS Database and Fidelity Investments, Monthly data from 1900 to 2024 as at December 2024.

Sensitivity matching through the lifecycle

Strategic investment design requires an evaluation of an investor's time-varying sensitivities. Financial wealth is principally built upon human capital (the present value of future earnings) and financial investments (e.g., savings, investments, home). The interaction of these two assets is influenced by the lifecycle investment journey.

Young investors have a majority of their wealth tied to human capital which is linked to the Canadian economy; this affords them the additional flexibility to seek more international diversification while maintaining appropriate exposure to Canada. As they age, and as wealth is converted from human capital into financial wealth, it is appropriate to redenominate assets to CAD which will be consumed in retirement. This can be achieved without sacrificing diversification. Currency-hedged fixed income introduces a variety of economic sensitivities to a portfolio without unintended foreign exchange volatility.

Exhibit 5: CAD exposure should evolve with changing investor sensitivities.

Source: Fidelity Investments as at December 2024.

Strategic investment principles

For two decades, we have been leaders in the Canadian target-date industry, helping plan members maintain their standard of living in retirement. In order to achieve this objective, we make research-driven investment decisions grounded in a time-tested investment process.

In our strategic allocation process, we strive to include asset classes that earn a return for bearing risk over a long-term investment horizon. Assets earn returns for their exposure to undiversifiable risk factors. In our view, the risk factors that have the largest effect on asset-class returns include surprises to economic growth, inflation, real (inflation-adjusted) interest rates and market liquidity.

While asset classes earn long-term returns for their exposures to risk factors, the actual emergence of these returns is time-varying. Our process for evaluating asset class diversification focuses on identifying distinct environments that we view as recurring over time with durable risk-and-return relationships among asset types. When applying our frameworks to assess asset types across the global capital markets, we think holistically about how asset classes work together. Given this, our selection process requires thoughtful consideration and evaluation of trade-offs. For example, an asset class that earns durable long-term returns may be excluded from the strategic allocation if its performance attributes are similar to those of other asset classes in the portfolio.

Our perspective in applying these frameworks is fundamental to the insights they yield. As we have discussed in this paper, Canadian investors have differentiated needs and sensitivities. The specific dynamics of the CAD in various market regimes, mentioned earlier, require insights to manage. Chief among these dynamics is that the CAD has a tendency to depreciate during equity sell-offs and to appreciate during growth expansions.

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