

## **BWMG RESEARCH COMMENTARY – Don't Forget to Stay Diversified**

When Canadian investors look back at their investment portfolio over the last several years, their reflections will generally be favourable. Other than the negative impact of the appreciating Canadian Dollar versus most major currencies, virtually all equity markets have performed well. However, there are two themes that have dominated over this period – strong Canadian Equity returns and the continued strength of Value Stocks. It is at times like this that investors must distance themselves from recent market phenomenon, consider their investment goals as documented in an Investment Policy, ensure their portfolio remains diversified and avoid chasing yesterday's market at the expense of a prudent long term investment strategy.

### **Canadian vs. Global Markets**

The worst performing year for the Canadian Equity market over the last four calendar years was in 2004 when the annual return was a “measly” 14.5%. The 4-year annualized return for the S&P/TSX Composite at December 31, 2006 is 20.5%. It certainly has been a difficult time to get Canadian investors excited about investing globally, when over the same 4-year period the Global market has returned CDN\$10.8% - still very respectable but about half the return of the Canadian market. However, it is important to remember that the Canadian Equity market represents only 3% of the market capitalization of publicly traded companies (735 stocks) while the remaining 97% worldwide is represented by over 15,000 publicly traded stocks. 75% of the Canadian market is held in 3 sectors (Energy, Financials and Materials) – while sectors such as Healthcare and Technology make up only 4% of the market. It is reasonable for a Canadian investor to have more than a 3% weighting in Canada due to home country bias – but one must consider allocating capital to the 15,000 companies outside of Canada. Furthermore, 574 of the 735 stocks in Canada are at a market capitalization (in US\$) below \$1.5 billion. Therefore, for Canadian investors it is important to consider Canadian small cap mandates which increase an investor's diversification within Canada.

### **Value vs. Growth Stocks**

After Growth stocks dominated the markets for much of the late 90's coinciding with the technology bubble, most investors expected that Value stocks would rule for several years. However, that leadership has been in place longer than expected – the 5 year return to December 31, 2006 for the Russell 1000 Value Index is US\$10.9% vs. 2.7% for the Russell 1000 Growth Index. This style domination is unprecedented. However, the market is now at a point where Value stocks are becoming expensive while many Growth stocks which have been overlooked for almost 7 years are attractively priced. In Canada the performance differential between Value and Growth stocks is less pronounced as it is difficult to differentiate between the two styles (Canadian Value index 5 year return is 15% vs. Canadian Growth index return of 11.3%). Large Cap Canadian Equity managers are limited to a universe of approximately 160 stocks (publicly traded Canadian companies with market capitalization above US\$1.5 billion) – it is not uncommon to find Canadian Value and Growth style managers overlap in upwards of 40% of their portfolio! Therefore, style diversification is less important in Canada but nonetheless is still beneficial. Investing in Canadian small cap stocks is a better diversifier.



### **Conclusion**

Warren Buffet often says that those that diversify do so because they lack conviction in their decision. We would love to have a crystal ball to be able to predict which market or style will outperform – but unfortunately we have yet to find anyone who can perform this function accurately and consistently. We do “lack conviction” when it comes to market timing and therefore recommend proper diversification. All our clients have carefully crafted Investment Policy Statements which are well thought out with long term investment goals which lead to diversification among style and asset class. Changing ones long term strategy based on past market performance would be imprudent. Stay the course!