How Much to Invest Abroad?

Individual investors may reap diversification benefits by investing internationally.

The level of benefit is based on many factors – cross-country correlations, major industries, domestic companies that operate globally, etc. Over time, global diversification benefits have fallen. However, investing outside your home country is still worthwhile.

The question then, how much should you invest abroad?

This question was asked of a panel in The Wall Street Journal. Some good responses. I will comment on a few and include my own view of the world.

My Thoughts (Since No One Asked)

The global market is 100%. Your domestic market is a piece of the pie. The U.S. is the largest financial market with about 33% (plus or minus – you actually may see some claim it as high as 46%, but that is too high) of global market capitalization. Canada has only about 4% of the global market share.

Some experts recommend investing in line with relative global weightings. So roughly 33% in U.S. equities, 4% Canada, etc. Fine by me. An easy way to do this is to simply purchase a global equity fund. For example, the Vanguard Total World Stock ETF (VT) or iShares MSCI All Country World Index (ACWI) ETF (ACWI).

Both are extremely inexpensive and do an excellent job of replicating the global equity markets in reasonable weightings. I use "reasonable" as global equity funds tend to overweight U.S. equities. In this case, both Vanguard and iShares invest about 48% in U.S. equities. The higher weighting in funds versus actual real world weightings has to do with investable assets and a slight U.S. bias. Not a huge issue if you are looking for one single fund to invest in. Canada's weighting sits at its proper 4%.

Some experts recommend home country bias when investing. If you live in Canada, instead of 4%, you might want to invest between 10 and 20% in Canadian equities.

Why? Your life is tied to your domestic financial markets. If you live in Canada, you are paid salary in Canadian dollars (CAD). Your debt is in CAD. Interest rates, inflation, unemployment, are all tied to Canadian-centric events. What goes on in Canada impacts Canadians disproportionately to world events. As a result, you may want to have greater exposure to Canadian equity markets.

I might add that some experts make the exact counter-arguement. That you should underweight your home market because of all the other impacts.

Me? I do not mind using either relative global weightings or home country bias. I think you need to consider other factors (what is your home market, debt load, other investments, cash flow requirements, etc.) before choosing one or the other. For many individuals who do not want currency and interest rate impact, a home country bias may be preferable. For younger investors, relative global weightings may prove better.

So what do the experts from The Wall Street Journal say? And bear in mind these folks are speaking as U.S. based investors. What might make sense for Americans may not be optimal for Aussies, Channel Islanders, or Malaysians.

Gus Sauter: Keep a Home Country Bias

> *In my view, investors should have a home-country bias because they face risks that are peculiar to their home country.*

> *So, an investor should invest a significant portion in their home country, but invest enough internationally to take advantage of diversification.*

Gus does not provide a suggestion for Aussies. But at 3% global weighting, a home country bias would probably put Australian equities at 10 to 20%. But some would say that more like 30 to 50% is suitable. Too high for me, but just letting you know.

As an aside, I have heard Gus speak a couple of times. Sharp guy.

Manisha Thakor: Don't Think About Where a Company is Based

> *As the consumer class around the globe continues to blossom, growth rates in emerging markets continue to eclipse those at home.*

Good advice. You need to consider the prospects for your home market versus foreign markets.

Also the region in which you live. If you live in Argentina, what goes on in Chile has more significance in your home market than what is happening in Germany. Conversely, Poles need to monitor the German market very closely given physical proximity and trade partnerships.

> *So the real question I think is: What is a non-U.S. investment?*
>
> *To date, corporate domicile has typically been the litmus test for the categorization of an investment as domestic or international. Going forward, I think it's important to pay attention to the source of revenue and profit generation*

So, so true.

Is Apple an American company? Much of its manufacturing is in China. Its customers surround the globe.

Is Nestle a Swiss company? Is Samsung only South Korean? HSBC solely British? Obviously not. These companies operate globally and derive much of their revenue outside their domestic markets. Yet if you look at each country's main indices, Nestle, Samsung, and HSBC dominate the domestic weightings.

As an aside, you can actually create an internationally diversified portfolio by strategically choosing domestic companies.

Frank Holmes: Anticipate Before You Participate

> *when you combine non-U.S. stocks, U.S. stocks, real-estate securities and commodity-linked securities, the resulting portfolio historically outpaced any individual asset class with less volatility.*
>
> *understand the typical price movements of an asset class before you invest.*

Not quite sure what Frank's point is here. Whenever you prepare a portfolio you must consider historic returns and volatility (i.e., risk). That really is the whole point of diversification. Adding non-correlated assets to try and enhance overall portfolio returns while maintaining the risk level. Or reducing portfolio risk while maintaining the existing expected return levels.

Charles Rotblut: No Crystal Ball? Then Best Diversify

> *unless a person has a working crystal ball, it is impossible to predict where one should invest right now to maximize returns for the next 10 years. By mixing domestic equities with foreign equities, an investor increases the odds of being allocated to the right geographic region at the right*

> *time.*

Diversification spreads out the risks. Unless you are certain of the future, hedge your bets.

> *by diversifying internationally, an investor's wealth won't solely be dependent on the strength or weakness of the U.S. dollar.*

This is a two-edged sword. If your cash needs (living income, debt repayment, etc.) are in your home currency, investments in foreign currency denominated assets might be risky. But if you do not have these concerns, owning assets in a different currency may add value.

The Other Experts

Mostly dross. But you can see that there is no consensus on how much to invest outside your domestic market.

If you have a decent risk appetite and long time horizon, look to higher levels of non-domestic equities. Especially in emergent (and smaller) markets.

If you have substantial liability exposure to your domestic currency or you require income flows in local currency, then focus on a significant home bias.

Emerging Market

Diversification

What do you think of when your hear the term, “emerging markets”?

What type of companies and industries exist in emerging equity markets?

I have no idea what you may think. But in case you do not know …

Emerging Markets May Mirror Developed Markets

In “iShares: Challenging Investor Assumptions About Emerging Markets”, ETF Trends compares portfolio holdings between emerging and developed markets.

> *But what’s so surprising to me is that over this 18 year period, how similar the sector weightings between these two types of markets has become.*

I like BlackRock and iShares. But if the article’s author is truly surprised by this similarity, I may need to rethink my view on BlackRock. That aside, realize that there are likely similarities between industries in equity market indices, whether they are emergent or not.

> *While investors often associate the emerging world with resources, these days, emerging markets are just as likely to be associated with banks. Financials make up 28% of the MSCI Emerging Markets Index, compared with a 22% combined share of energy and materials and, interestingly, a 21% financials share in developed markets.*

Mirrored Industries, But Still Local Flavour

True. And worth keeping in mind when seeking diversification through different asset classes and markets. But I would add though that this is not 100% accurate.

You need to look at local population, proximity to other markets, natural resource base, availability of labour, etc., as these items greatly impact what goes on in any one country. Country (and industry, company) specific factors influence local companies to a great extent.

Compare Switzerland to Canada. Both developed markets. Lots of natural resources in Canada, so you would expect related industries to dominate major indices. Lots of milk producing cows in Switzerland, hence Nestle as a major company. Not all developed markets are homogeneous.

Or compare the emerging markets of Brazil to Poland. Yes, Brazil is considered (for now) an emerging market. Country specific factors impact major industries. If we break down the major industry exposures, we see financials (Brazil 28% versus Poland 45%), energy (B 16%, P 14%), consumer staples (B 15%, P 4%), materials (B 15%, P 16%), and utilities (B 7%, P 8%). In some industries, extremely close percentages. In others, significant variance. Depending on which emerging markets you invest in, you may discover high similarity or you may find low. Part of your research into which funds you want should consider this point.

Even if companies operate in the same industries, there will be some significant differences in results based on local factors.

A bank operating in Poland may have a relatively low correlation with a bank in Brazil. There are common factors that inherently keep correlations high (global economy a big one). But there are local factors (customer base, local economy, government, trading partners, etc.) that reduce correlations. The greater the difference in local specific factors, the lower the correlations (and the better the diversification).

I would expect correlations between Brazilian and Argentine banks to be higher as compared to Brazilian and Polish banks. Owning a Brazilian, Polish, and Vietnamese bank will provide better diversification than three Canadian banks.

Energy accounts for 16% of Brazil and 15% of Poland equity markets. Very similar percentages in industry allocation. Petrobras makes up a large portion of the Brazilian component. PKN Orlen a large portion of Polish energy. If you go to the links, both are indeed energy companies. But Petrobras is the 7th largest energy company in the world and operates in 25 countries. It is renowned for deep water oil exploration. Whereas PKN Orlen specializes in refining crude oil. Both energy, but different emphasis. That provides diversification benefits.

Yes, there can be similar industries and percent composition between developed and emergent markets (as well as between developed markets or emerging markets). But the local situation and circumstances will lower asset correlations to some extent. Which means you can still get diversification benefits from investing in emerging markets.

Increased Globalization Increases Correlations

Okay, let's rein in the "diversify with emerging markets" horse a little.

Twenty years ago, investing in emerging markets provided strong diversification with domestic market investment portfolios. That was the investing mantra.

With each passing year, the world seems to get smaller. Domestic companies in developed markets increasingly operate in emerging and frontier markets. Emerging markets, especially larger ones like Brazil, Russian, India, and China (known collectively as BRICs), have extensive trade relationships with developed nations. This results in ever increasing correlations as the differences between developed and emergent continues to blur.

You can still get enhanced portfolio diversification by investing in emerging markets. Just realize that the benefits are decreasing over time. And that individual portfolio holdings within an emerging market index may be quite similar in nature and ratio as in your home developed market index.

It is beneficial to include emerging market equities in one's portfolio. But do not blindly assume that simply including them will bring positive results. Consider the components of the emerging market index. How they relates to your domestic equity holdings, as well as how they correlate to other emerging and non-domestic developed markets you wish to invest in.

Active Manager Praises Passive Funds

Next we will see cats lying with dogs.

In "ETF Expense Ratios Between Countries", I looked at how the same fund can have widely different expense ratios depending on which exchange it was listed.

I read an interesting article that reinforces a key point I made. And adds a couple more worthy of note.

In "Active Manager Praises Passive Funds", Wilfred Hahn talks about the proliferation of exchange traded funds. A few interesting points:

Proliferation of Cost-Effective Investment Options

Ten years ago, Hahn recalls, there were only about 150 ETFs globally. Now, with nearly 5,000 ETFs in his investment universe of potential picks, there's very little need to trade on overseas exchanges. Nearly all of the ETFs that the portfolios now hold are listed on either the Toronto Stock Exchange or U.S. exchanges. "That's good news because it makes international investing more cost-effective," Hahn says.

In 10 years, from 150 ETFs to 5000. A lot more investment options.

I looked at this issue of ETF proliferation previously. More is not always better. You need to watch out for a few potential problems.

Maybe cost-effective for North American investors today. Over time, I expect to see the rest of the world's developed markets improve their fund offerings. And the more competition, the better the cost structures in the funds. Good news for investors around the world.

ETFs Covering All Investment Needs

At least 75% of each portfolio will consist of core holdings in equities, fixed income and cash. Some or all of the remaining 25% may be held in more opportunistic investments, such as ETFs dedicated to specific commodities. Hahn and his colleagues have identified more than 60 asset types that can be held via ETFs.

ETFs allow for investing in a wide range of asset classes and subclasses.

Yet the bulk of Hahn's portfolios remain invested in the three core asset classes. It goes to show that investors can do quite well without having to branch out into exotic or alternative investments. Focus on your core. As you accumulate significant wealth, then consider augmenting your portfolio.

A key reason why you probably do not need alternative asset classes?

Consider a very simple example in the TSX 60. The largest 60 stocks in Canada. You want real estate exposure? You got Brookfield Asset Management. Oil and gas? Canadian Natural Resources. Gold? Goldcorp. Silver? Silver Wheaton. Copper? First Quantum Minerals. Nuclear energy and uranium? Cameco. Agriculture and potash? Potash Corporation.

That is just one example for each. There are more for various alternative investments. Heck, you can even invest based on (the highly profitable) Canadian consumption of doughnuts (and low cost coffee).

And given the countries where many of these companies operate and/or market their products, simply investing in the TSX 60 provides substantial global exposure.

Buying these 60 largest Canadian traded companies, you get more than mere plain-vanilla Canadian-centric equities. If you look at any major index around the world, you will see that the companies within typically cover a wide range of industries and world regions.

These major indices are very good for portfolio diversification. You may not need to supplement your core portfolio with alternative asset classes or geographic markets. Your home market index may provide adequate diversification.

As an investing aside, I prefer a broader Canadian index. For example, the TSX Capped Composite Index. Whereas the TSX 60 covers about 73% of the Canadian equity market, the Composite covers 95% with 257 companies included. Slightly more diversification and exposure to companies and industries. For example, the Composite includes additional alternative asset classes like diamonds (Dominion Diamond) and timber (West Fraser).

ETFs Aid in Prudent Portfolio Management

> *Hahn seeks to avoid what he calls "classic" portfolio mistakes such as not enough diversification, too much risk and too little fixed income. His exclusive use of ETFs, as opposed to direct holdings in stocks and bonds, enables him to minimize company-specific risk.*

Note that Hahn uses passively managed ETFs (i.e., pure index ETFs) to create tactically managed portfolios. That is very different than an actively managed ETF. And for more experienced investors, I have no issue with tactical asset allocation strategies. I employ them myself in my business. More for longer term trends though than market timing.

For a look at strategic versus tactical allocation, Investopedia reviews a few styles.

Regardless of approach, index funds can definitely assist in enhancing portfolio diversification and risk management on a cost efficient basis.

It is what I recommend to you.

As your total capital and expertise accumulates, then consider expanding into non-traditional asset classes and possibly tactical asset management. But wait until your wealth grows. And more importantly, you develop strong investment knowledge and experience (or work with a competent financial advisor).

Tips to Diversify Your Portfolio

Diversification is crucial for long-term investment success.

Proper diversification, that is.

Today, how to better diversify your investment portfolio.

A Quick Refresher on Diversification

We covered diversification a while back, so just a quick reminder on this important concept.

What is portfolio diversification?

A little deeper look into portfolio diversification.

Portfolio diversification in action.

Portfolio diversification and asset correlations.

Diversify with emerging markets.

Mutual fund holdings and diversification.

Efficient and effective portfolio diversification may be the main determinant of long-term investing success or failure. Please make certain you understand this crucial subject.

Investopedia provides "5 Tips For Diversifying Your Portfolio". We have covered these tips before, but it is a nice summary.

1. Spread the Wealth

Reduce your portfolio's non-systematic risk (i.e., the diversifiable risk) by spreading out your capital. Diversify within and between individual asset classes (e.g., equities, fixed income) and asset sub-classes (e.g., natural resource equities, junk bonds). Diversify across geographic regions (e.g., emerging, developed) and time (e.g., 5, 30 year bonds).

There are diminishing returns to diversifying. And the benefits of diversification are more a function of the correlation between the assets selected, not simply the number of investments you make.

2. Consider Index or Bond Funds

Cost effective. The funds are often well-diversified within the tracked index. And it is easy to create a diversified total portfolio with very few investments (though each fund will have a large number of holdings).

For example, consider the iShares S&P 500 index exchange traded fund (IVV). You buy one single investment product. Yet you receive the benefit of 500 companies representing a wide variety of the U.S. equity market. All for a minimal annual cost of 0.07%.

3. Keep Building

Fully agree that dollar cost averaging can aid in effective diversification.

Dollar cost averaging promotes investing discipline, a consistent approach, and portfolio quality. It is an excellent investing technique for small investors.

4. Know When to Get Out

I like a general buy and hold approach when investing in mutual and exchange traded funds. I do not think buy and hold forever works with non-diversified investments, like individual stocks or bonds.

One has to be aware of potential problems, but I think the advantages of buy and hold for funds win out for investors.

I like buy and hold. But that does necessarily mean buy and hold (forever, locked away in a drawer). Buy and hold, but review. As necessary, rebalance your actual asset allocation back in line with your target allocation. There are a few strategies available to rebalance.

5. Keep a Watchful Eye on Commissions

Yes, watch commissions on mutual funds. I recommend seldom (usually never) buying into any fund that charges a commission. There are too many good no-load funds out there.

Besides commission, keep an eye on all your investment related expenses.

Brokerage fees when buying or selling mutual funds, exchange traded funds, stocks, bonds, etc.

Annual expenses charged to an investment product. These can significantly impact investment returns for both mutual funds and exchange traded funds. They can also materially differ between investment products and offerings. So do proper due diligence prior to investing in any one product or fund.

Why? I cannot tell you which fund or asset class will outperform next year. But I can tell you with some confidence that lower costs will result in stronger performance over time.

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3 Essential Investment Rules

StreetAuthority looks at three essential investment rules of master investor, Peter Lynch.

Excellent investment advice for those wishing to invest in individual equities.

Unfortunately, I do not know any non-professional investors who could actually follow two of the three keys. Ah, the joys of investment advice.

Only Invest in What you Understand

A good point. But what does the average investor understand?

First, most investors should avoid complex investments such as options, futures, forwards, commodities, etc. Stick to traditional fixed income and equities to go with cash balances.

But what about equities? The normal investor should have a well-diversified portfolio. That means small, medium, and large cap stocks, in a variety of industries, throughout multiple geographic locations.

If you are only supposed to stick with things you know, how can a Canadian investor add Russian, Australian, or Japanese stocks to the portfolio? Or the British investor may know something about Coca-Cola, Bank America, and McDonald's, but has he ever heard of smaller companies like Rush Enterprises, Sonic Automotive, and CommVault Systems? I haven't.

In this era of globalized markets, I am not sure one can stick only to investments that you understand. Even with traditional fixed income and equities, if you only invest in what you know, it will be difficult (impossible) to create a well-diversified and effective portfolio.

Understanding the Fundamentals of a Company is Key

Also a good point.

If you analyze companies as part of your investment process you do need to look at fundamentals. The "quants and the quals" if you want to talk sexy and impress my nephew.

But how many amateur investors understand ratios including, percentage of sales or price/earnings to growth? I am not even certain the article's author fully understands percentage of sales, as he states:

> *Be certain the item or service that first attracted you to the company makes up a significant portion of its sales.*

What is "significant portion"? 20%, 40%, 80%?

What about if you were attracted to Blackberry products, then Apple comes along with the iPhone and eats RIMs lunch (and dinner)? The "eggs in one basket" thing can be a problem.

What about having a single client that purchases a significant of the company's product? Is that good? Hint: no.

With price/earnings to growth (PEG):

> *When the PEG hits two or higher, it may mean future growth is already built into the stock price.*

It "may mean"? Is this a rule you should carve in stone? Nope.

> *It's important to note that the PEG ratio is best suited for non-dividend paying stocks, since it does not take dividend returns into consideration.*

That is good to know. I am glad that not many companies pay dividends. Oh wait. Lots of companies pay dividends?

You also want a company with a:

> *Strong cash position, little debt*

As stated in the article, important for dividend paying companies (that is, the ones that are not suited for PEG calculations). What the …?

This cash to debt is another ratio that might be a positive, but is often a negative. For example, how do companies grow? They use internal cash flow, raise capital, or borrow money to invest in their business. Research and development of new products, marketing existing services, buying new equipment and plants, expanding operations into new regions, etc. If you are sitting on a pile of cash, are you likely growing your company (which usually means higher share prices as profitability also grows)? Probably not.

Yes, investors do need to analyze the fundamentals. But it sure helps if you have the technical knowledge and experience to comprehend the numbers.

For a thoughts on a few common ratios, check out price-earnings, price-book, dividend yield, and growth premiums.

Also recommended, a comparison of investing for growth versus value investing.

Invest for the Long Haul

A third good point. One I can actually agree on without an asterisk.

Take a long-term perspective. Do not sweat the short-term volatility.

I would be a little cautious on taking a long-term strategy for individual stocks. Yes, some companies have dominated for many years. But technology and other variables can change very quickly. Be very careful employing a buy and hold strategy for individual stocks. You may miss out on the next Apple while holding on to Eastman Kodak.

What Should You Do?

Focus on your investor profile and the resulting target asset allocation. The process is more important to long-term investment success than the actual individual holdings.

Invest consistently in low-cost, well-diversified investments. That means passively managed index exchange traded or open ended mutual funds.

The nature of index funds is such that as the quality of the underlying holdings change, weaker stocks are deleted from the index and up and comers added. While you may not be buying at the best time nor selling at the peak, you do get some protection and benefit from the index adjustments over time.

As an added bonus, by investing in well-diversified funds, you do not have to analyze the fundamentals or completely understand the individual holdings. Your focus will be on your target asset allocation, not on the underlying components.

For a refresher on what you should do, please read my "Summary on How to Invest".

Want to Invest Like a Pro?

Want to learn how to invest like a professional investor?

Maybe a good plan, maybe not. But our friends at Investopedia discuss how to "Invest Like a Pro".

Article highlights and my comments below:

Strategy Before Investing

> *A strong investment philosophy should be outlined before any investment strategies are considered. An investment*

> *philosophy is the basis for investment policies and procedures and, ultimately, long-term plans. In a nutshell, an investment philosophy is a set of core beliefs from which all investment strategies are developed.*

Per Investopedia, the keys to developing a strong investment philosophy are in defining your: core investment beliefs; investment time horizon; risk tolerance; target asset allocation; diversification.

Basically what we talked about in developing your Investment Policy Statement.

You start out by creating a comprehensive Investor Profile. It takes into account your current financial situation, investment objectives and constraints, time horizon, and personal risk tolerance. The result should be used to drive your investment strategy. And by investment strategy, we are talking your target asset allocation, including diversification and asset classes.

I firmly believe that if you take the time to lay a proper foundation it will improve your actual investment decisions and long-term performance. Sadly, too many individuals ignore this part of the investing process.

Secrets of Success

Match Investments to Investor Profile

> *Successful firms also implement product funds that reflect their investment philosophies and strategies.*

Develop an investment plan that meets your individual situation. Then invest in appropriate products that will best meet your goals.

If you are retired, highly risk-averse, and need investment income to meet your monthly cash flow requirements, then lower risk assets that provide a consistent cash flow are best. But if you are 25, with a 40 year investment window, and do not require investment income to live, then perhaps you are best suited for more volatile investments with higher potential returns.

Match your investments to your personal situation and profile.

As your circumstances change (family, approaching retirement, career success, etc.), you should adjust your profile. As a result, your investment strategy, target asset allocation, and individual investment choices will also evolve over time.

Avoid Sector Bets

> *Successful firms also limit their abilities to take large sector bets in their core products.*

Not sure I necessarily agree with this one, or at least with Investopedia's phrasing. I think what Investopedia means is that one should not deviate from the core approach to make significant bets in any specific sectors or sub-asset classes.

For example, you have a well-diversified equity portfolio, but the financial pundits all say that tech stocks are the place to be during the upcoming year. So you ditch your utilities, commodities, retail, etc., and load up on tech equities. This is what Investopedia seems to be referring to.

The issue here is essentially market timing. And can you, or even the professional investors, correctly time market (and sub-market) movements? History shows that very few professionals get it right.

How often to economists get it correct? I could post examples like this every week if I wanted. Or what about the best investment analysts out there. Why do the "best" seem to change every year? How many professional investors were screaming when Apple dumped Steve Jobs back in the 1980s? Or why do mutual funds typically lag their pre-determined benchmarks if fund asset managers can time short-term market movements and trends?

The classic passive versus active management debate. It is difficult to beat the market, do not try.

If you are jumping in and out of sectors, you will incur higher transaction costs, as well as lose potential capital by timing poorly. You are investing for the long run. Select a strategy that meets your unique situation and follow it. Do not get caught up in the short term noise and stay the course.

Fully agree. Well, with short term sector bets or chasing trends. However, I do make longer term sector plays. Does that make me a bad guy? A fool? Possibly.

Well, Avoid Short Term Sector Bets

I am more a macro investor, so that is what I do myself to a large extent. I study trends and recommend investments that fit those trends. But I am more interested in medium to longer term trends. I do not think it possible (at least for me) to time short term volatility and I utilize probabilities more than gut feel.

If you ask me what Apple will do over the next 6 months, I can analyze the data and provide a reasoned opinion, but my confidence level will be low. There are too many non-systematic risks in play with individual companies to assess performance. Consider UBS. How many people out there knew a rogue trader in London was going to create so much aggravation for the company? Not me.

This is why we use diversification. To minimize non-systematic risks in our portfolios.

It is also why I recommend passive investing, utilizing a diverse portfolio of low cost index funds.

Looking at systematic risk, how many investors anticipated the September 11, 2001 attacks? Huge short term impact on the financial markets. The S&P 500 fell 11.6% between September 10 and September 21. Yet a month later it was back to pre-attack levels.

So short term volatility and market timing is hard to accurately assess. Or so I believe.

But I do think that smaller, professional investors can take advantage of inefficient markets and longer term trends.

Consider interest rates in Canada or the U.S. Currently, they are extremely low on a historic basis. In a low, medium, and high probability analysis, the odds of interest rates falling are negligible. We can debate forever as to whether they will remain stable or increase over the next 3, 6, 9, 12, or 24 months. But I am pretty confident they will rise over the medium term, if not the short.

Without getting into the correlation between interest rates and fixed income prices, suffice to say when rates fall, bond prices generally rise. When rates rise, bond prices fall. And the impact is greater the longer the bond's duration (term to maturity, in layman's terms). If I think rates will fall, I want to own 30 year bonds. If I think rates will rise, I want to hold 1 year bonds. As I calculate a higher probability of rising rates going forward, I believe that investors should shorten their fixed income portfolio durations.

But that is me. I listened to the two top guys at Vanguard last week make a slightly different argument (when they put up a video for the talk, I will post it). They said that perhaps low rates will stay in place for a longer period. By reducing durations, you are giving up yield (generally speaking, longer maturities equals higher yield) needlessly if rates do not increase. And they made some excellent points in support of their position.

If Vanguard is correct and I am not, then I am costing myself income by placing a sector bet on short-term duration bonds. We shall see over time. But I do think for an amateur investors – the doctor, teacher, fireman, etc., who does not spend 10 hours a day studying the markets – stick to a general strategy and that will serve you well over time.

Stay Consistent and Disciplined

> *When defining an investment strategy, it is very important to follow a strict discipline.*

The chasing trends part we covered above. But I highlight the discipline part also in respect of consistency over time.

Use a dollar cost average approach to gradually build your holdings. When markets are down, you will be buying at a discount. When markets are too high, you will buy less and avoid overpaying. You likely cannot time market or individual investment highs and lows. So buy a fixed dollar amount each week, month, or quarter. That will smooth your purchase prices over time and better serve you.

Stay disciplined in your investment style. If you cannot time market volatility, should you even try?

A Final Thought

It is said that a picture is worth a thousand words.

Here is a good example of market volatility and whether one can time markets.

How many investors were able to time the market lows in early 2009? Versus the number that bought in mid-2008? But if you consistently invested $1000 monthly over that period, you may have done all right.

[Signs of Portfolio Over-Diversification]

A well diversified investment portfolio is a key requirement for long-term investing success.

Diversification is important. But sometimes too much diversification can negatively impact portfolio performance. It can be a fine line in getting it right.

Today, a look at indications your portfolio is overly diversified.

Portfolio Diversification

We have looked at the benefits of portfolio diversification in previous posts. Should you wish to refresh yourself on this important concept, please take a read of:

[An Introduction to Diversification]

[A Little More on Diversification]

[Portfolio Diversification in Action]

[Diversification and Asset Correlations]

[Diversify With Emerging Markets]

Pretty creative titles. What else to expect from an accountant/finance guy? At least I am not an actuary. As the saying goes, an actuary is simply an accountant without a sense of humour.

Bottom line, proper diversification is extremely important for investing success.

But too much diversification can hurt performance.

Indications You May Be Over-Diversified

Investopedia offers [“Top 4 Signs Of Over-Diversification”]. The article has good observations.

1. Owning too many mutual funds within any single investment style category

> *Investing in more than one mutual fund within any style category adds investment costs, increases required investment due diligence, and generally reduces the rate of diversification achieved by holding multiple positions.*

For each investment category, find a single mutual or exchange traded fund that meets your investment criteria for that class. This should be fairly straightforward for passive investing. If you are investing with active fund managers, you may want to look at two or three funds to hedge the managers’ performance.

Also, watch for too little diversification when buying [multiple funds in the same investment style category]. The pool of available investments within an investment class may be small, so you may end up with very similar holdings in two or more funds. Or, some investments span multiple investment style categories. You may just end up with Apple in every fund you own regardless of style category.

Watch the underlying holdings in any funds you research. Do not spread yourself too thin or pay for the same fund twice. And be careful with costs. Let your capital accumulate on your behalf. Not on making the fund company rich.

2. Excessive use of multi-manager investments

> *When considering multi-manager investment products, you should weigh their diversification benefits against their lack of customization, high costs and layers of diluted due diligence. Is it really to your benefit to have a financial advisor monitoring an investment manager that is in turn monitoring other investment managers?*

I am not a fan of fund of funds and/or multi-manager investment products. There are some investing aspects where it may be cost-effective to hire professional expertise (financial planner, active managers in specialized markets, etc.). But any individual investor should be able to put together a portfolio of funds on their own. Why pay someone to amalgamate a variety of readily available funds?

3. Owning an excessive number of individual stock positions

> *Too many individual stock positions can lead to enormous amounts of required due diligence, a complicated tax situation and performance that simply mimics a stock index, albeit at a higher cost.*

The greater the complexity of a fund, the greater the costs you will usually pay.

A problem with this is that outside of certain index funds (e.g., the SPDR Dow Jones Industrial Average (DIA) reflects the Dow's 30 components), most funds will have significantly more holdings than the 20 to 30 normally cited for adequate diversification. Is holding 184 investments in the fund materially more cost effective than 227 holdings?

Or what about a fund that only has 60 investments but is constantly churning the portfolio? Is that better or worse than a fund with 300 investments that has very little turnover?

Me, I tend to focus more on two things. One, I look at the percentage of total fund assets in the top 20 or 30 holdings. That tells me something on the real concentration of assets. Two, I focus on the annual expense ratio for the fund. That tells me about management fees, transaction costs, administration expenses, etc., for the fund.

4. Owning privately held "non-traded" investments that are not fundamentally different from the publicly traded ones you already own

> *Non-publicly traded investment products are often promoted for their price stability and diversification benefits relative to their publicly traded peers. While these "alternative investments" can provide you with diversification, their investment risks may be understated by the complex and irregular methods used to value them. The value of many alternative investments, like private equity and non-publicly traded real estate, are based on estimates and appraisal values instead of daily public market transactions. This "mark-to-model" approach to valuation can artificially smooth an investment's return over time, a phenomenon known as "return smoothing."*

Most investors should be able to go through their lives without investing in these types of alternative investments.

I have owned some of these investments but tend not to recommend them to non-professional investors. Valuations can be problematic. Proper management is important. Cost structures tend to be relatively high. Also, liquidity can be an issue for investors wishing to divest. I suggest using caution when considering non-publicly traded investments.

Too much diversification may negatively impact your portfolio performance. Not necessarily from having too many investments. But in the increased costs associated with those additional funds and holdings.

Vanguard 2012 Economic Outlook

As we move through 2012, uncertainty exists over global economic and financial markets.

Which countries' economies will prosper? Or maybe the better question is, which countries' economies will not completely crater in 2012? Which equity markets should investors consider? What should I do about all the market volatility?

There are many concerns out there for investors.

Vanguard considers these questions in, "Vanguard's Long-term Outlook for Stocks and the Economy". A short article, but one that contains some decent commentary. For example:

Will the U.S. recovery stay on track in 2012?

> *I think the recent data have been upbeat, which is a testament to the resiliency of the U.S. private sector.*

That’s why we think the recovery will continue to endure, more likely than not, although there’s no guarantee.

Not carved in stone confidence, but positive about the U.S. economy.

I am less bullish on the U.S. currently.

There is still extreme uncertainty on the upcoming U.S. presidential election. I believe a Romney win will be better for the economy than if Obama is re-elected. That said, while Republicans talk a good game about fiscal responsibility and lowering the U.S. national debt, their actions are not representative of their talk. It took more than Obama and his crew to get the U.S. deficits and debt to where they are today. And Romney is not known as a huge fiscal conservative.

Unless people get real about the level of debt – if for no other reason than the sheer amount of tax revenues that must finance interest payments and not grow the economy – the U.S. will continue to stumble along. And I just do not see that happening anytime soon.

Should investors be worried about high market volatility?

The markets have been volatile, but it’s easy to forget that markets always go through volatile periods.

But I think we’re all more sensitive now after the global financial crisis of a few years ago. This may be hard to believe, but in the last nine years, the U.S. stock market finished in negative territory in only one year, 2008. So it can be helpful to keep the longer-term perspective and remember that the reason we look for higher returns in equities is because the markets are volatile. Over time, investors have been compensated for the risks that they take in stocks. So we try to coach people to expect short-term volatility and to not overreact to it.

Very good point to keep in mind. The level of attention by the public to equity markets is very high. And I think that people remember that bad news more than the good. The media definitely contributes with its "if it bleeds it leads" mentality.

Volatility is risk as measured by the [standard deviation of an asset's returns]. The more volatile an investment, the greater the risk. But the greater the risk, the higher the expected return. Investing 101 in a nutshell.

If you wish to achieve higher long-term performance, you need to take on risk (to some degree). That is why younger investors should look at (relatively) riskier asset classes as opposed to older investors. Young investors have a longer time horizon to withstand short and medium term volatility.

What about the sovereign-debt problems here and in Europe?

> *The fear of contagion has subsided lately, as it looks more likely that Europe will muddle through.*

I am much less positive on Europe. They talk, they plan, they make cosmetic changes. But never seem to address the core problems that have created this problem in the first place.

And if you do think Europe is serious about getting their fiscal house in order, I give you the new French President, Francois Hollande. His idea of fiscal responsibility is to lower the retirement age for [certain workers from 62 to 60]. That should go over well with the Germans (who have a retirement age of 67), Poland (67), Sweden (increasing to 69), Britain (increasing to 66), and even Italy (increasing to 66 for males, 62 for females).

What's Vanguard's longer-term outlook for stocks?

> *But again, we can't predict what's going to happen in the next year. So if you're saving to spend on something a year*

from now, you shouldn't be in the stock market. But if you're saving for a child's education 15 years from now, or for retirement 20 years from now, what asset class do you think is going to provide the highest rate of return?

Again, this reflects the link between an investor's time horizon and their investment objectives. The longer the time horizon, the greater the investment risk that can be assumed.

But remember that all investors – even the young- have short and medium term objectives.

Maybe you are 25 and want to retire at age 65. You have a 40 year time horizon for retirement investing. Long term. Assets with higher volatility probably makes sense.

But maybe you want to buy a new car next year and will need $20,000 cash for that purchase. A short term objective. You probably do not want an investment that may swing 50% each year in case it is down over the next year when you need funds to buy that car. Same if you plan on buying a home in 5 years.

You always need to match your investment objectives to your specific investments. And all of you will have short, medium, and longer term objectives and constraints, regardless of age.

With negative headlines and volatility, should investors change their strategy?

To us, that means stepping back and asking yourself what is the best long-term asset mix for your situation. And once you figure that out, maybe with an advisor's help, then I think you put a plan in place to get to your allocation of stocks and bonds. That's what's going to drive your portfolio's returns.

Then you don't have to continually second-guess yourself, wondering, for example, if you should sell a bond fund if you think interest rates are going to go up. Even if that

> *happens, your stock portfolio can help to offset the decline in bonds. That's the advantage of diversification. You have one asset class that can support the other. You keep both because you don't know which one needs to support the other over the next year or two.*

Very good advice. Take a long term approach. Focus on asset allocation and diversification.

> *I encourage our clients to try to minimize the attention they pay to economic news, because I think that can actually lead to the pitfall of wanting to react. The market can discount economic news very quickly—I mean in a matter of seconds. So, while it's good to be well-versed on the economy, we have to guard against overreacting to it, because there's much more to investing and seeking long-term returns than analyzing the latest economic news.*

Avoid getting caught up in the flavour of the day. If you have followed the FaceBook public offering you know what I mean. Before the issue, the focus was on how to get shares and be part of the FaceBook phenomena. Now it seems to be, how bad an investment is FaceBook and should (former wonder-boy) Zuckerberg be sued?

> *market volatility presents an opportunity to be proactive by doing things like rebalancing. That can be a powerful antidote to the volatility, because if stocks or bonds fall, you can rebalance to your target allocation. "Buy and hold"—an approach we endorse—doesn't mean "set it and forget it."*

Something I strongly believe. Utilize a buy and hold strategy for long run success. But always make sure that you periodically review and rebalance as necessary. Buy and hold does not mean buy and forget.

I would also add that market volatility also allows for discount purchasing. If you utilize [dollar cost averaging](), volatility aids in buying higher volumes when prices are depressed and relatively less when valuations are running high.

Dangers of Dividend Funds

Dividend funds are currently very popular with investors.

In many parts of the world, interest rate yields are quite low on a historical basis. To enhance returns, fixed income investors have turned to riskier investments that may offer higher yields. Such as dividends on preferred shares or dividend paying common shares.

As well, general equity investors are turning to perceived "safer" equity investments. Common shares in large, dividend paying companies. Shares that provide capital gains potential over time, but are back-stopped by a (hopefully) steady stream of dividend income.

Sounds like a good strategy to me. But there are always risks when investing.

Here are a few things to consider when assessing dividend funds (or dividend paying shares).

A Flight to Dividend Funds

The Wall Street Journal's, "The Dangers of Dividend Funds", looks at a few perils with dividend investments.

The first thing though that interested me was the flight of investors to dividend funds.

> *This year through May 1, investors have taken about $2.65 billion out of U.S. stock funds overall—while placing a net $12.72 billion in mutual funds and exchange-traded funds that focus on dividend-paying stocks, according to EPFR Global.*

That is a lot of money, just in the U.S. alone. Given what is going on in the world right now – low interest rates, economic uncertainty, potentially higher inflation, volatility in the equity markets, etc. – I have no problem with investors shifting assets to dividend paying stocks.

If you are someone who wants to increase your asset allocation in dividend stocks, make sure you consider the following points.

Do Not Simply Chase Performance

Past performance is no guarantee of future results.

You will see that in every mutual fund prospectus you read.

Evaluate your needs going forward. What investments make the most sense in light of your objectives, constraints, and personal situation (i.e., Investor Profile).

Investing based on prior performance is usually not a recipe for long-term investment success.

Concentrate on Your Optimal Asset Allocation

Your Investor Profile will lead to an Investment Policy Statement with a target asset allocation for your unique needs.

Part of your optimal asset allocation will include fixed income and dividend producing investments. But the amount will reflect your individual circumstances.

Focus your investment portfolio on your asset allocation and not on chasing the flavour of the day. In the long run, I believe this will be the more successful approach.

Remember the Risk-Return Concept

I think that the major financial markets are relatively efficient. That means that the price of an asset should reflect its future. And the price of the asset is what drives the dividend yield.

Perhaps a one year Treasury bill (i.e., the risk-free asset) yields 4%. You can invest in that or you could invest in common shares of ABC company with a dividend yield of 7%. 4& versus 7%. A fairly easy choice.

But why is ABC yielding 7%? It could be because ABC is a forgotten stock or has been poorly analyzed, so that it is under-valued. And that could be true for small companies, companies in ignored markets, etc. Areas where a single, informed investor might gain a competitive advantage. But for larger companies in established markets, these companies tend to be analyzed to death.

So (again) why the 7% yield? Because ABC is significantly riskier than the Treasury bill. And that greater risk is reflected in the higher offered dividend yield.

Perhaps the company's cash flow may not allow ABC to continue paying out the same dividend amount. That may cause future yields to fall. Or perhaps ABC's business prospects are in question. That may hurt the future share price. While you maintain a 7% yield on the dividend, you may just find your capital slipping away as the share price falls. So you earn 7% annually in dividends, but perhaps you lose 25% on your initial capital investment. That may make your annualized total return much less attractive.

Bottom line: when seeing an investment that offers a very generous return, always ask yourself why? It could be an under-valued gem that you have found. Or the relatively high yield could indicate investment difficulties down the road.

Diversification

If investing in dividend stocks, make sure that you diversify within this category.

Some dividend funds concentrate in very narrow ranges and that can cause problems.

For example, bank stocks often pay good dividends. So you go out and buy a dividend fund that focusses on Canadian bank stocks. However, Canadian banks are highly correlated (they tend to move in lock-step). If you own a fund with 10 Canadian bank stocks, your diversification is poor. If you do want bank stocks, consider global banks to reduce some of the geographic issues. Better still, consider dividend paying companies from a variety of industries and countries.

Always watch the diversification within any one fund. If the fund's holdings are too concentrated, the inter-asset correlations will be high, resulting in poor diversification.

Taxes May Be Your Biggest Expense

Always consider tax consequences.

Your investment focus must be on after-tax returns. Never focus on gross returns.

For example, in Canada, dividends receive preferential tax treatment versus interest income. Say you earn $10,000 in dividend income from shares in Royal Bank and $10,000 in interest income on Royal Bank bonds. You will pay less tax on the dividend income than on the interest. So your net return will be higher with the dividends.

But not all dividends. Only dividends sourced from an eligible

Canadian corporation receive the dividend tax credit. Your $10,000 in dividends from Bank of America will receive the same tax treatment as your interest income.

And not all portfolios. Investment income earned inside a tax-deferred investment account is obviously treated differently than income earned in a non-tax-deferred account.

When assessing dividend funds, never consider the publicized rates of return. Understand your personal tax situation and then invest to optimize your net returns.

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8 Keys to Financial Security

Knight Kiplinger, head of Kiplinger financial media, created a nice asset management video.

8 Keys to Financial Security is exactly that. Tips for protecting your assets and growing wealth.

As per usual, I add my two-cents to Mr. Kiplinger's wealth management recommendations.

Kiplinger's 8 Keys to Financial Security

I like this short video because it reminds me of something created in the 1950s (it seems to have been created in 2011 though). Kind of like a Simpsons' episode where Bart or Lisa is forced to watch an outdated instructional movie in school.

But while the video is a little quirky, the points are very relevant and useful.

httpv://youtu.be/Lx3b9-5hHiI

1. Invest in Yourself

This is why I write about education and career issues in a wealth management blog.

Individuals invest their capital in stocks, bonds, and so on. But you need to create that capital first. The more wealth you can create, the more you can save and put to work for you. Therefore, the best investment that you can make is to invest in yourself.

Invest in, not spend on yourself. Always look at the cost-benefit of any expenditure.

That may be technical skills in high demand industries (not puppetry or poetry). Complementary skills – such as industry specific knowledge, basic business skills for technical graduates, or foreign languages – that add value to your core training. There are many ways to improve your chance of career success.

2. Protect Yourself and Your Loved Ones

The need for protection depends on your personal situation and job.

If you are young, with a new family, insurance is a great way to protect your family if something happens to you. But if you are single, maybe insurance is not a big need.

As you age, perhaps your family assets will provide all the security you require. Or perhaps your job includes disability and death coverage.

Examine your unique needs. Reevaluate your needs over time and whenever a significant event takes place in your life. Then decide if insurance is necessary. It just may be.

3. Borrow Sparingly

If it was me, I might say borrow prudently rather than sparingly.

I understand, and agree with, Kiplinger's belief. Borrow for appreciating assets (home) or required large expenditures (car for work). Avoid borrowing on wasting assets.

I differ in that I am comfortable with prudently borrowing for investment purposes. Leverage, used responsibly, can enhance returns. But it must be used prudently and only by those who understand investing and its risks.

I also differ a little on borrowing for homes and houses. Do not borrow beyond your needs or ability to comfortably repay.

Banks like to lend money. They make great profits off consumer loans and mortgages. Banks will happily lend you as much as you can tolerate and repay. Not what you need.

You need a car for work? You have $15,000 in cash, but based on your financial situation the bank is happy to lend you $85,000. Should you take advantage of the entire offer and buy a brand new BMW? Or should you only borrow $5000 and buy a slightly used, but still under warranty, vehicle for $20,000? Borrow if you must, but borrow wisely. The interest you will pay on that $85,000 loan will cost you dearly in the long-term.

4. Pay Yourself First

Use direct deposits so that you never see the money. If you do not have that $100 (or more) in your account every month, you cannot spend it. And like rent, utilities, loan repayments, etc., you quickly get used to not having the cash on hand.

Most mutual funds provide direct debit investing options. Sometimes initial purchase requirements may be high for small investors (but not with all fund companies, so check around), but usually subsequent purchases are very reasonable in size.

You can also look at other investing options that simplify share acquisition. Dividend reinvestment plans (DRIPs), direct stock purchase plans (DSPPs), and employee stock purchase plans (ESPPs) may allow for direct investing in a company's shares.

5. Don't Go For the Home Run

Finding that next Apple or Google is great, but difficult to do. Individual investors strike out many more times than hit a home run.

That is why I typically recommend a steady, consistent investment strategy. One that passively invests in well diversified, low cost assets. Using dollar cost averaging and a general buy and hold approach.

6. Diversify, Diversify, Diversify

I might even add a fourth diversify.

Diversify between asset classes, within an asset class, and by time.

How you diversify is based on your unique investor profile and Investment Policy Statement.

7. Live Simply Today

Remember our discussions on compound returns?

A dollar saved today grows substantially over time.

You can try to keep up with the Jones's now. Or you can scrimp a little today and surpass them in retirement.

8. Give Generously of Yourself

I shall leave the giving back to each of you.

My only comment on charitable donations is to know where your money is going.

There are too many charities that distribute too much money to staff salaries and advertising versus using that money for its stated purposes. Check out a charity’s financial statements before contributing your hard earned cash. Your money may be going to pay the President’s salary or lobbying efforts instead of helping that starving family or curing a disease.