RBC Global Asset Management

Global diversification is key to long-term success

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Sarah Riopelle, CFA
Vice President & Senior Portfolio Manager, Investment Solutions
RBC Global Asset Management Inc.

It has been a few months since I published my last LinkedIn article, and what a difference a few months can make! Since then, we have experienced a pandemic and unprecedented market volatility.

The COVID-19 crisis has contributed to the largest and most abrupt shock to global growth in modern history, but it has had an uneven impact on various countries and regions in terms of severity as well as timing. Some regions were impacted earlier and have since recovered, and some are continuing to deal with the crisis. Some countries thought that they had seen the worst only to experience a second wave, while others escaped relatively unscathed. There continues to be a lot of uncertainty as to how the next few months and quarters will play out. This uncertainty means volatility will likely remain high as the economy and markets continue to recover from the impact of the pandemic.

Pandemic leads to market divergence

When I published my last article in mid-April, we had just come through the shortest bear market in history, although at the time it was still too early to say whether it was over. With bond yields near historic lows, we have seen a significant recovery in stocks since the equity-market bottom in late March. However, not all equity markets have recovered at the same pace. There has been significant divergence between the best- and worst-performing segments of the market in 2020. The table highlights the varying degrees to which markets around the world have responded to the crisis and shows divergences that are likely to persist as markets continue to recover from the impact of the pandemic.

Asset class performance

	YTD	1 year
Fixed Income		
Global Sovereign	6.1%	6.8%
Global IG	4.9%	6.0%
High Yield	0.2%	3.6%
Emerging Markets	-0.4%	1.5%
Equities		
Canada	-3.3%	1.9%
U.S.	5.6%	13.6%
Europe	-6.5%	0.7%
Asia	1.4%	9.2%
Emerging Markets	1.5%	8.7%
USD/CAD FX Rate	**3.3%**	**1.7%**

Note: Data as of July 31, 2020. C$ returns shown. Global Sovereign=FTSE World Government Bond Index (WGBI) C$ Hedged, Global IG=Barclays Global Agg Index C$Hedged, High Yield=ICE BoAML US High Yield BB-B Index (C$ Hedged), Emerging Markets Bonds=JP Morgan EMBI Global Diversified (C$ Hedged), Canada=S&P/TSX Composite Index, US=S&P 500 Index C$, Europe=MSCI Europe Net Index C$, Asia=MSCI AC Pacific Net Index C$, Emerging Markets equities=MSCI Emerging Markets Net Index C$.
Source: RBC GAM

Looking at Canada, the weak performance of domestic equities so far in 2020 has likely had a disproportionate effect on investors when you consider that the average Canadian has 90% of their assets tied to Canada. While not necessarily a Canadian phenomenon, this home country bias can result in significant country-specific risk due to the concentrated nature of our capital markets. For this reason, we recently reduced our strategic allocation to Canadian equities in favour of global equities across many of our balanced and multi-asset solutions. Canadian equity performance is highly dependent on a handful of sectors, namely Financials, Energy and Materials. The performance of these sectors is influenced by the outlook for interest rates and commodity prices, which are in turn tied to global economic growth. Given the weak economic environment that we are experiencing, it isn't surprising that the Canadian economy and markets have underperformed.

If recent history has shown us anything, it's that diversifying across and within asset classes, and taking a global view, is an effective way to manage volatility. Such an approach can help you to reduce the impact of localized downturns and diversify your sources of investment returns across multiple regions.

> "While the basic principles of diversification haven't changed over the years, how we diversify our portfolios has. Taking a global approach to diversification is a critical component to managing volatility and positioning portfolios for the future."

We often use the table below – known as the "quilt" – to demonstrate this idea. It shows that no single market has consistently outperformed any other over the past 10 years. It also shows that a globally diversified portfolio exhibits less volatility year-over-year relative to individual asset classes and markets. That is because we are spreading risks across multiple markets so that the performance of a single investment cannot have an outsized impact on portfolio returns. While this might mean that you have to give up some performance on the upside, it helps to minimize your downside and keeps you invested through short-term market declines like the one that we just experienced.

Asset class returns over the last decade

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020 YTD
CDN Equities 17.6%	CDN Bonds 9.6%	US HY Bonds 16.1%	US Equities 41.2%	US Equities 23.9%	US Equities 21.5%	CDN Equities 21.0%	EM Equities 28.7%	US Equities 4.2%	US Equities 25.1%	CDN Bonds 8.9%
US HY Bonds 14.8%	Global Bonds 6.4%	EM Equities 16.0%	INTL Equities 31.5%	Global Balanced 12.3%	INTL Equities 19.4%	US HY Bonds 16.9%	INTL Equities 17.3%	Global Bonds 1.9%	CDN Equities 22.9%	Global Bonds 6.1%
EM Equities 12.9%	US Equities 4.6%	INTL Equities 15.2%	Global Balanced 19.1%	CDN Equities 10.5%	Global Balanced 11.2%	US Equities 8.0%	US Equities 13.4%	CDN Bonds 1.4%	INTL Equities 16.5%	US Equities 5.8%
US Equities 9.0%	US HY Bonds 4.4%	US Equities 13.4%	CDN Equities 12.9%	Global Bonds 9.3%	CDN Bonds 3.5%	EM Equities 7.7%	Global Balanced 10.6%	Cash 1.3%	Global Balanced 15.0%	Global Balanced 3.1%
CDN Bonds 6.7%	Cash 0.9%	Global Balanced 10.6%	US HY Bonds 8.1%	CDN Bonds 8.7%	EM Equities 2.4%	Global Balanced 4.5%	CDN Equities 9.1%	Global Balanced -0.2%	US HY Bonds 13.3%	EM Equities 1.7%
Global Balanced 6.1%	Global Balanced 0.5%	CDN Equities 7.1%	EM Equities 4.2%	EM Equities 7.0%	Global Bonds 1.9%	Global Bonds 3.5%	US HY Bonds 6.9%	US HY Bonds -3.1%	EM Equities 12.9%	Cash 0.6%
Global Bonds 3.8%	CDN Equities -8.7%	Global Bonds 5.3%	Global Bonds 0.9%	INTL Equities 4.1%	Cash 0.5%	CDN Bonds 1.6%	CDN Bonds 2.5%	INTL Equities -5.5%	CDN Bonds 6.9%	US HY Bonds -1.4%
INTL Equities 2.5%	INTL Equities -9.5%	CDN Bonds 3.5%	Cash 0.9%	US HY Bonds 3.2%	US HY Bonds -4.5%	Cash 0.4%	Global Bonds 1.7%	EM Equities -6.5%	Global Bonds 6.8%	CDN Equities -3.3%
Cash 0.4%	EM Equities -16.1%	Cash 0.9%	CDN Bonds -1.1%	Cash 0.8%	CDN Equities -8.3%	INTL Equities -1.9%	Cash 0.6%	CDN Equities -8.8%	Cash 1.7%	INTL Equities -6.0%

Note: Composition of global balanced portfolio: 1% FTSE TMX Canada 30 Day T-Bill Index, 39% Bloomberg Barclays Global Aggregate Index (Hedged), 1% S&P/TSX Composite Index, 30% S&P 500 Index, 22% MSCI EAFE Index, 7% MSCI Emerging Market Index. Indexes used to represent each of the asset classes shown: Cash = FTSE TMX Canada 30 Day T-Bill Index, Global Bonds = FTSE World Global Bond Index (Hedged), Canadian bonds = FTSE Canada All Government Bond Index, US HY Bonds: ICE BofA US High-Yield BB-B Total Return Index, Canadian equities = S&P/TSX Composite Index, U.S. equities = S&P 500 Index, Global equities = MSCI EAFE Index, Emerging market equities = MSCI Emerging Market Index. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes, which would reduce returns. Past performance is not a guarantee of future results. All performance in $CAD.
Source: RBC GAM, Morningstar, as of January 1, 2010 to July 31, 2020.

What can investors expect from the global economy and markets going forward? As countries ease lockdown measures, the most prominent risk is that the virus regains traction and forces economies into a second closure. The U.S. election in November and the deterioration of U.S.-China relations could also serve as sources of volatility for global economies and financial markets.

As the past six months have shown, markets are unpredictable and risks can surface quickly and unexpectedly. It is often difficult to foresee these developments in advance, so taking a globally diversified approach will help to mitigate the impact of these events on portfolio returns. As I have said before, and you will hear me say many more times in the future, global diversification is key to long-term success.

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