



TD Economics

Special Report

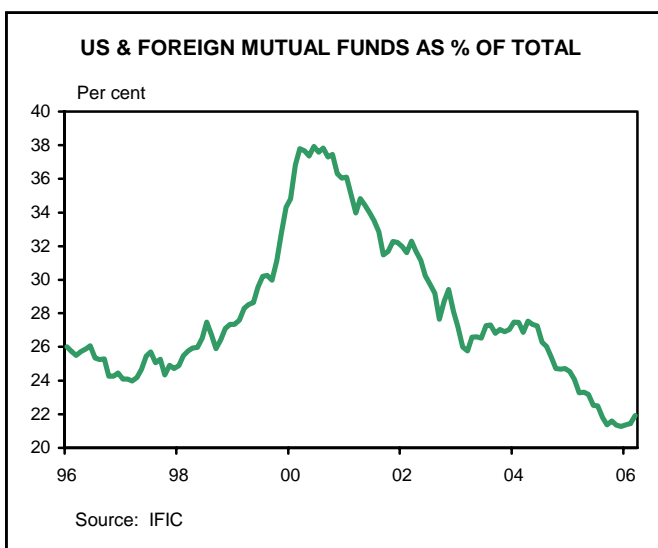
September 5, 2006

10 REASONS CANADIANS SHOULD INVEST ABROAD

At TD Economics, we have the opportunity to travel across Canada speaking to financial planners, investment advisors and individual investors. Recently there has been one message that we have repeatedly heard: Canadians are reluctant to invest abroad. Trends in mutual fund holdings support this observation. According to the Investment Funds Institute of Canada (IFIC), the value of investments in U.S. and other foreign mutual funds stands at only 22% of total holdings, down from 38% in 2000.

Convincing Canadians to consider foreign investments can be a hard sell, especially given the out performance of the Canadian equity market in recent years. From the third quarter of 2002 to the second quarter of 2006, the S&P/TSX Composite Index soared by 88%, representing the second best performance across the industrialized world.

Understandably, Canadians feel a greater sense of security in the domestic corporate landscape, where the companies are more familiar and the Canadian dollar-dominated investments are insulated from foreign exchange risk.



WHY TO INVEST ABROAD?

1. Canada is a small market
2. The S&P/TSX Composite is dominated by energy and financial services
3. Some industries are not represented, or are weakly represented, in the S&P/TSX
4. Canadian market is highly cyclical
5. International markets provide diversification
6. International valuations look attractive
7. Higher dividend yields can be found abroad
8. International structural trends are positive
9. Growth opportunities from emerging markets
10. FX volatility should not deter foreign investing

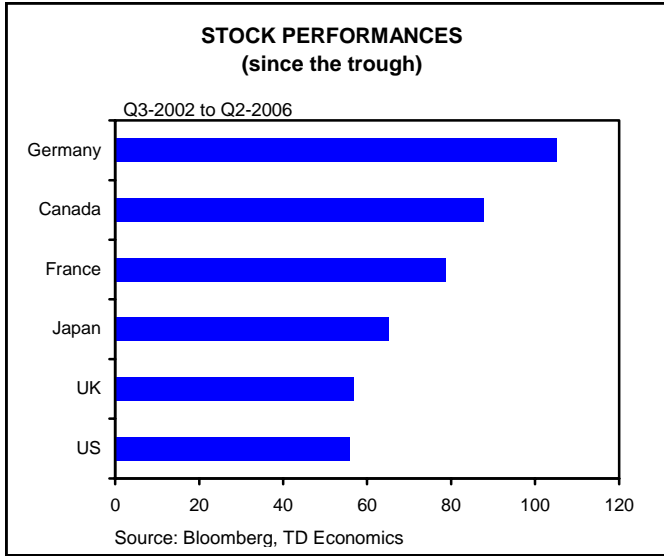
However, it is well known that geographic diversification can improve investment returns without increasing risk.

Appropriate asset allocation will differ depending on individual risk tolerance, but most portfolios should have some foreign exposure. For example, the benchmark for the TD Waterhouse balanced growth portfolio has a 60% equity exposure, which is broken down to being 15% Canadian equities, 26% U.S. equities and 19% International equities.

The main message is that Canadians could miss out of financial opportunities by restricting their attention to the domestic market. And, if you need further convincing, here are our top 10 reasons to invest abroad.

1. Canada is a tiny market

Canada is a small part of global capital markets, rep-



representing 3.5% of global equities and a mere 2% of the world economy. In other words, 96.5% of all possible equity investments are outside of Canada. An investor with a heavily concentrated Canadian equity portfolio over the past four years would have missed out on the strongest performing index during that period – the German DAX index. Meanwhile, Japan’s Nikkei index was the top performer among industrialized nations in 2005. This illustrates the fact that it is rare for a single nation’s stock exchange to hold the top seat year after year.

2. The TSX is not diversified

The Canadian equity market is dominated by a few sectors. Energy and financial companies represent an overwhelming 60% of the composite index, with the weighting split almost evenly between the two at 30.6% and 30.2%, respectively. Over the past four years, energy has been responsible for half the increase in the S&P/TSX Composite Index, while financials have accounted for one-third of the gain, leaving the other 8 major industry groups to contribute the remaining 20%.

One of the key tenets to financial planning is diversification, and this is simply not provided by the industry weightings in the S&P/TSX. In contrast, many international stock indexes are more balanced. About one-quarter of the U.S. stock benchmark (S&P500) is exposed to energy and financials. The rest is a broad mix, including information technology, consumer goods, and health services.

3. Some industries virtually absent in the TSX

The small scale of the market means that some industries

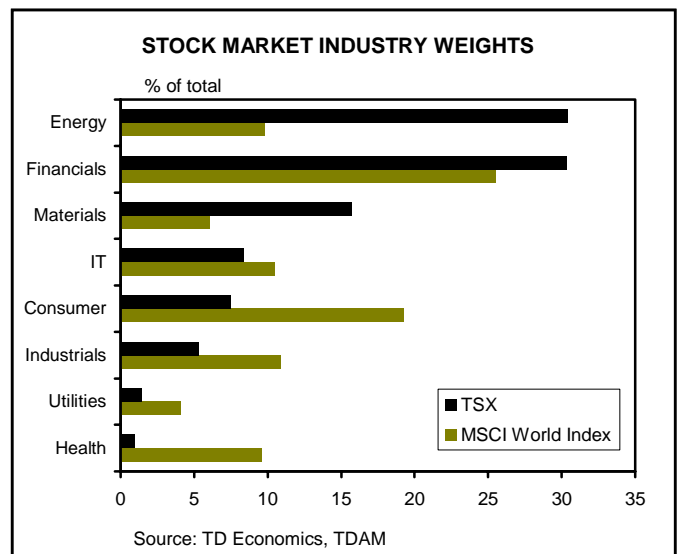
are virtually unrepresented in the S&P/TSX, while the corporate choice within selected other sectors can be extremely limited. For example, individuals looking to invest in pharmaceuticals, health care, defense or information technology will find many more opportunities in international markets than in Canada.

4. Canadian market is highly cyclical

The high weighting of commodities leaves the S&P/TSX highly vulnerable to cyclical swings. Almost half of the index is impacted by changes in energy and non-energy commodity prices, which are historically volatile. There is no denying that the commodity exposure has been a windfall in recent years, but what goes up, often comes down.

Consider the recent experience of natural gas prices. In response to strong demand and rising oil prices, natural gas had reached US\$13.6 per million British Thermal Units (MMBtu) in December 2005. The assumption was that this environmentally friendly energy source would remain in high demand over the short, medium and long-term. Then mild weather arrived and inventories shot up unexpectedly. By July, the price of natural gas plunged to less than US\$6, and the recovery has been modest, with prices still holding below the US\$7 mark. This serves as a good reminder of how quickly commodity prices can change direction.

It is important to stress that the recent broad based commodity rally has corresponded with the strongest world economic performance in more than three decades. Any moderation in growth could negatively impact commod-



ity prices and Canadian equities.

5. International markets provide diversification

There have been claims that international equity markets are becoming more correlated, limiting their ability to provide diversification. To some extent, this is true. Global equity markets have increasingly moved in step since 2001. However, this is a very recent phenomenon and it is related to the synchronized growth in the global economy. History shows that an economic down cycle tends to separate the wheat from the chaff. For instance, the 1997-1998 Asian financial crises resulted in a sudden drop in commodity prices and a 16% slide in the S&P/TSX over the course of a year (Q4-97 to Q3-98). During this same period, the U.S., German and French stock markets gained 5-6%, reflecting the natural hedge provided with countries of different industry compositions and economic growth prospects.

A common held belief is that those who pursue the rewards of investing abroad incur higher risks, but the opposite can be true. The explanation lies in the old adage of putting your eggs in one basket. Adding foreign stocks to a portfolio is simply an act of diversification that, by its nature, should lower portfolio risk. To understand why consider the following:

First, the industry composition within benchmark equity indexes is different.

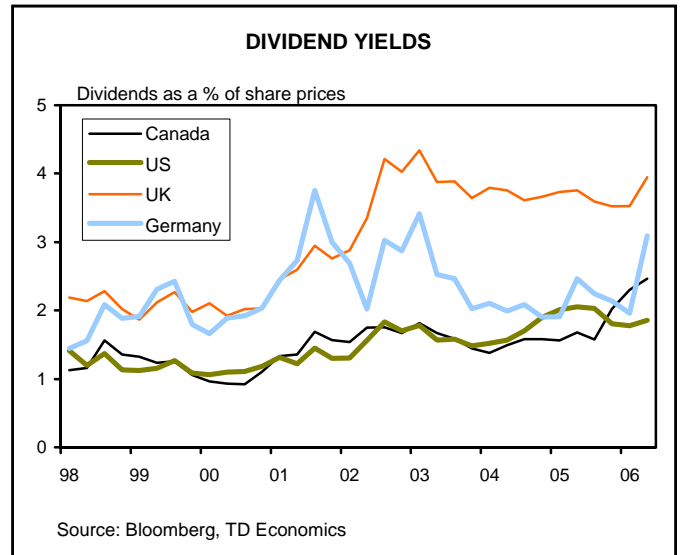
Second, central banks and governments around the globe generally do not move in lock step with monetary and fiscal policy.

CORRELATIONS BETWEEN TSX & INTERNATIONAL RETURNS

Monthly equity returns from given date through 7/2006

	Jun-92	Jan-88	Jan-84	Feb-80
TSX	1.00	1.00	1.00	1.00
DJIA	0.69	0.70	0.74	0.73
S&P500	0.75	0.74	0.77	0.77
Wilshire	0.80	0.78	0.81	0.80
FTSE	0.60	0.60	0.64	...
Germany	0.61	0.59	0.56	0.51
France	0.63	0.57	...	...
Spain	0.59	0.54	...	...
Japan	0.43	0.43	0.43	0.39
Australia	0.62	...	...	...
EAFE	0.70	0.61	0.58	0.58
South Korea	0.38	0.36	0.33	0.29
MSCI EM EUROPE	0.56	0.42	...	...
MSCI EM ASIA	0.57	0.57	...	...
MSCI EM LATIN AMERICA	0.59	0.33	...	...

Source: Bloomberg



Third, regional trends vary, with the recent China and India boom being a good contrast to more sluggish economic conditions in some segments of Europe.

Lastly, globalization is not a new phenomenon, and yet the correlation in equity returns between the S&P/TSX and international indexes has differed greatly.

6. International valuations look attractive

The most fundamental equity investing rule is buy low and sell high. Unfortunately, Canadian stock valuations are no longer cheap. Since 2001, double-digit growth in Canadian corporate profits has been met with an even faster climb in equity prices. Aside from the tech bubble period – which nobody wants to repeat – the price-to-earnings (P/E) ratio for the S&P/TSX Composite is at a historically high level, with stock prices trading more than 19 times earnings. Among the G-7 benchmark exchanges, Canada has the highest P/E valuation. In contrast, the S&P500 has become steadily cheaper, trading at 17 times earnings even though U.S. corporations have delivered equally robust profits. The U.K. and German benchmark indexes are at even lower multiples.

7. Higher dividend yields can be found abroad

Numerous studies have shown that dividends are a critical source of shareholder returns over the long haul, and here too international stock exchanges can provide opportunities. The dividend yield for the Canadian and U.S. stock exchanges has averaged 1.5-2% over the last decade, palling in comparison to consistently higher European exchanges. In fact, the U.K. benchmark stock exchange (FTSE 100) generally returns a dividend yield twice that

INCOME PERCENTAGE OF TOTAL RETURN		
Length of Rolling Period	U.S. Equity	U.K. Equity
5 Years	43.0%	48.0%
10 Years	50.0%	55.0%
20 Years	63.0%	68.0%
78 Years	96.2%	97.7%

Source: Brandes Institute

of the North American exchanges, and in the past three years it has ranged between 3.5-4%.

Research also shows that dividends are a critical source of equity returns. Over a 20-year period in Canada, the U.K. and the U.S., reinvested dividends accounted for two-thirds of the return on equities. Looking ahead, a sustained low inflation, low interest rate environment implies that dividend yields will continue to be a key source of investor income.

8. International structural changes are positive

Since global profits bottomed in 2002, a number of countries have made significant strides to improve their competitive positions on the global stage. The graph on the following page contrasts the rapid growth in productivity experienced by Japan and the U.S. relative to other major industrialized countries. In fact, these two countries are even outperforming their own past productivity cycles. U.S. productivity growth among non-financial firms is leaps and bounds ahead of past cycles when profits were rebounding from the trough. Meanwhile, Japanese firms have largely succeeded in tackling the excesses

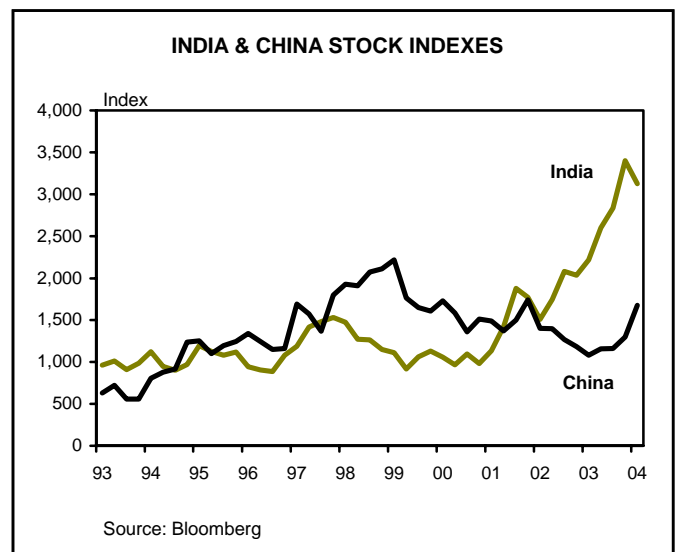
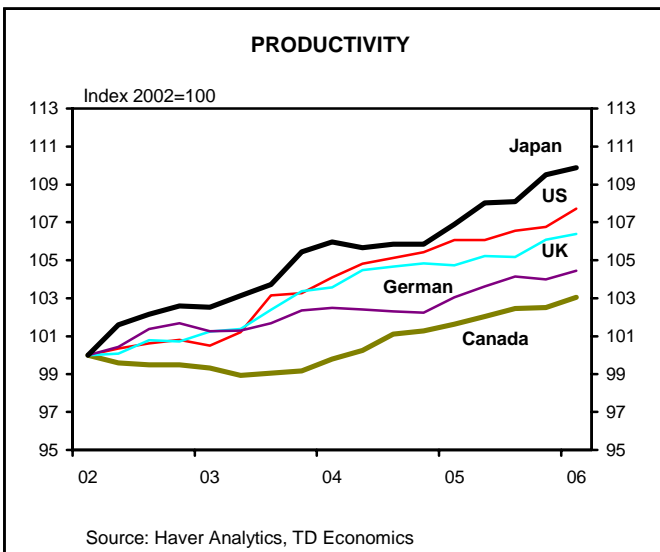
of the 1990s by trimming costs, reducing unused capacity, and reducing their liabilities. Although structural reforms have moved at a slower pace in Continental Europe – largely due to labour market rigidities – there is still evidence of significant progress. For instance, German firms have improved bottom lines by lowering unit labour costs and investors have rewarded their efforts with the value of the DAX doubling over the last four years.

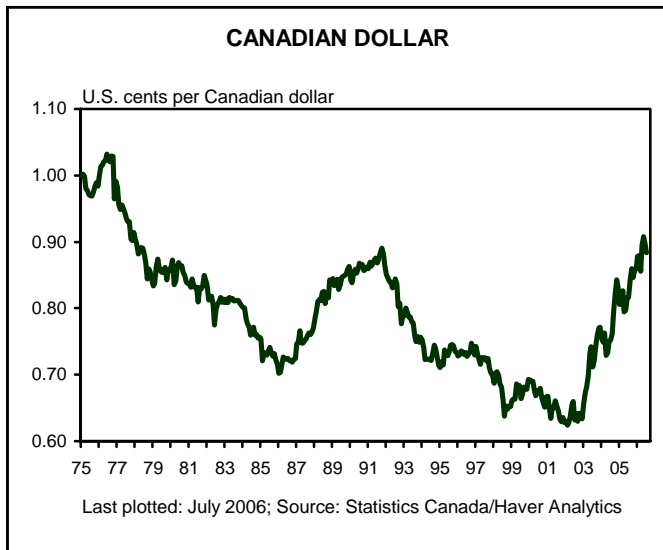
Canada’s economic fundamentals are robust, with sustained low inflation, strong labour markets, healthy corporate balance sheets, and surpluses in international trade, current account and federal finances. However, this has not translated into strong productivity growth, causing Canada’s relative position to have slipped.

9. Emerging markets and high growth opportunities

There is a global fascination with the high growth prospect of emerging economies, especially India and China. Perhaps with good reason, as India’s benchmark index posted a stunning return of 225% from the trough in 2002 to the second quarter of 2006.

Although rapid growth economies offer the possibility of high stock returns, timing is critical and investors should be cautious in their approach to these investments. For example, China has been the fastest growing country over the last 20 years and yet the benchmark Shanghai index appreciated, on average, only 4.3% over the last four years. Basic finance theory shows that high risk opportunities can pay off handsomely, but the downside is equally probable, especially in emerging markets where stock exchanges are inherently 3 times more volatile than those in





developed economies. In addition, accounting and regulatory standards in emerging economies are often less robust than in industrialized nations.

One alternative way for investors to profit from the rapid economic growth in energy markets with less risk is to invest in companies that are located in well regulated markets, but that are still have leverage to places like China and India. For example, the number one exporter to China is Japan. So, Japan has a large number of export-oriented firms that will benefit from the economic boom in China. Likewise, there is a large number of North American and European companies that generate a significant amount of their revenue from emerging markets and these firms are spread across a wide array of sectors.

10. Don't be deterred by FX volatility

Finally, a common refrain is that Canadians don't want to invest abroad because the foreign currencies might weaken against the Canadian dollar, wiping out any capital gain. This reflects recent experience when the strengthening in the Canadian dollar relative to the U.S. dollar offset half of the increase in the S&P500 over the past four years.

However, the risk of foreign exchange volatility should not be a deterrent to international investing.

First, the greatest move in the Canadian dollar is likely

behind us. The loonie went from below 62 U.S. cents to around 90 U.S. cents, and it is highly improbable that there will be another such gain in the years ahead. TD Economics believes that the upside to the currency limited to a few cents, at best.

Second, exchange rate volatility works both ways, as it can often enhance capital gains. Canadian investors that realized capital gains benefited from a weakening currency throughout the 1990s. And, the strong Canadian dollar at the moment, means that it costs less than in the past to buy foreign equities.

Professional portfolio managers will often factor foreign exchange rate prospects into their decisions. For example, fixed-income managers often invest in foreign bonds with the hope, or expectation, that exchange rate movements will add to the coupon yield of the underlying asset.

Finally, there are many financial products that allow investors to hedge their exchange rate risk, including currency-neutral mutual funds geared to foreign markets.

The bottom line

There is no doubt that Canada is a great place to invest. The economy is strong and its long-term fundamentals are in great shape. Canadian equities have benefited from a bull market in commodities since 2002, and we believe prices for many raw materials will generally continue to hold well above their historical averages over the next several years. But this does not detract from the recommendation that investors hold a well diversified portfolio that has some exposure to foreign markets. In particular, international investments provide access to additional sectors and growth prospects, higher dividend yields and attractive valuation plays. And, while a floating Canadian dollar could impact returns, there are ways to find shelter, or even profit, from exchange rate movements.

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