

INTERNATIONAL INTERESTS

Smart Money: Investing Internationally

Brad Brain



Canada is a great country. In international surveys we consistently come out near the top as one of the best places in the world to live. We have clean air, wide-open spaces, and we won Olympic Gold in both men's and women's hockey.

So Canada is a great place to live, but is Canada a great place to invest? Unfortunately, no. If you had invested \$1000 in Canada 15 years ago, you would have \$3086 today. If you had invested \$1000 in the US 15 years ago, you would have \$5990 today, almost twice as much.

(Source Paltrak, July 2003, TSX Composite Index and S&P 500 Index)

Not only do Canadian investments underperform, we underperform with style. It is not unusual for the volatility of an investment to increase as the expected return of the investment increases. Canadian investments are, however, impressively volatile, despite not having the historical performance that we would hope goes along with that volatility.

The reason for this is pretty simple. On a global economic scale, we are minnows. Canada represents about three percent of the global stock market. To invest exclusively in Canada means you are foregoing about 97 percent of the world.

Investing internationally offers some compelling benefits. More growth for your investments, which is great. But also diversification. Everyone has heard the investing cliché, "Don't keep all your eggs in one basket." Intuitively this makes sense. If Canada has a bad year (as it is known to do) and all your investments are in Canada . . .

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Many investment decisions are based on emotion and emotional investment decisions are often bad investment decisions. When properly structured, diversifying your investments internationally can offer you better returns while actually reducing the amount of volatility in your portfolio. Diversification can ease the psychological effect of market volatility and help take the emotion out of investing.

Many people who invest do so via their Registered Retirement Savings Plan (RRSP). CCRA has dictated that the

maximum foreign content allowed in an RRSP is 30 percent of the book value of the RRSP.

The RRSP foreign content limit is an artificial constraint that is not consistent with how a rational investor would behave. Given the choice, very few people would elect to have 70 percent of their retirement nest egg invested in just 3 percent of the world—and a volatile, underperforming 3 percent at that!—and 30 percent of their nest egg spread out over the 97 percent of the world that is not in Canada.

Fortunately, there are ways to increase your international investment exposure and still stay onside with CCRA's foreign content rules. One way is with RRSP clone funds.

A clone fund is an RRSP-eligible investment fund that will derive its value from an underlying international investment fund. That may sound a little intimidating, but this is not really any more risky than investing directly in an international investment fund. There are about 448 of these funds in Canada with assets in excess of \$20 billion, so the concept is well established.

It works like this: an investment fund company has a successful international investment fund that it

wants to open up to RRSP investors. An investor deposits \$100. The fund company invests \$30 internationally, as per the foreign content rules. With the remaining \$70, the investment company enters into a contract with a third party, typically a chartered bank. Since the investor's money is with the Canadian bank, it is considered a Canadian-content, RRSP-eligible investment.

The bank agrees to provide the same return as the underlying foreign investment, less their fees. It is quite simple to do this; the bank simply invests the \$70 into the foreign investment. The bank is not trying to speculate on the returns of the investment. They get their cut by charging for their service. The extra expense to involve the third party is usually quite modest. Generally it is about 0.05 percent of the money invested. (That's 0.0005, not 5 percent.)

It is important to diversify your portfolio effectively to reduce risk, increase potential returns, and encourage a long-term perspective. Investing internationally is one of the best ways to diversify. RRSP clone funds are one way to achieve significant diversification while working within CCRA's foreign content rules.

Historically, diversification has always paid off. RRSP clone funds can help you secure a well-balanced, diversified portfolio designed to attain long-term goals with an appropriate level of investment risk. ▲

Mutual funds are not guaranteed; their values change frequently and past performance may not be repeated. Commissions, trailing commissions, management fees, and expenses all may be associated with mutual fund investments. Please read the prospectus prior to investing.

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