

# Advisor *Info*

## Investment

### Diversification

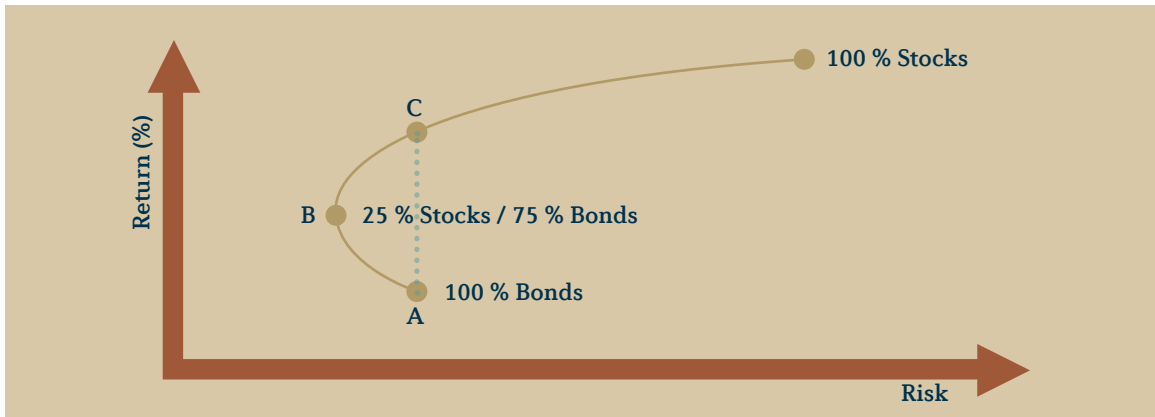
... or the art of managing the risk

- ASSET CLASSES
- THINK GLOBAL
- MANAGEMENT STYLE

The experts agree that an excellent strategy for reducing several risks and increasing the performance potential of your investments is to diversify – in other words, to avoid putting all your eggs in one basket. Concentrating your investments in one instrument can be a risky choice for an investor (just think about anyone who invested everything in Nortel or Enron). A simple solution is to add a number of securities to your portfolio, thereby eliminating a large portion of the risk associated with an individual security.

Some investors avoid adding stocks to their portfolio to steer clear of the volatility associated with them. They may not realize that in a well-diversified portfolio, stocks can generate a greater potential return without significantly increasing volatility.

The graph below illustrates the theory of efficient portfolio selection<sup>1</sup>. A portfolio is considered efficient when, for a given level of risk, it offers the maximum expected return or, conversely, for a given level of return, it offers the lowest level of risk.



Between two portfolios that offer the same level of risk (A and C), a rational investor will select the one that offers the higher expected return (C). Looking at the curve, we notice that the portfolio containing more bonds (between B and A) is not an efficient portfolio. The efficient portfolio is the one that includes a larger equity component (located between B and C) as it offers a better expected return for the same level of risk.

It is therefore essential for investors to adopt a sound diversification strategy in order to make the most of their investments while properly managing risk. All investors should, in accordance with their investor profile, properly diversify their investments in four main areas: asset classes, geographic regions, sectors and management styles. Such a strategy provides good protection against market fluctuations.

Let's look a little more closely at the fundamentals of this diversification strategy.

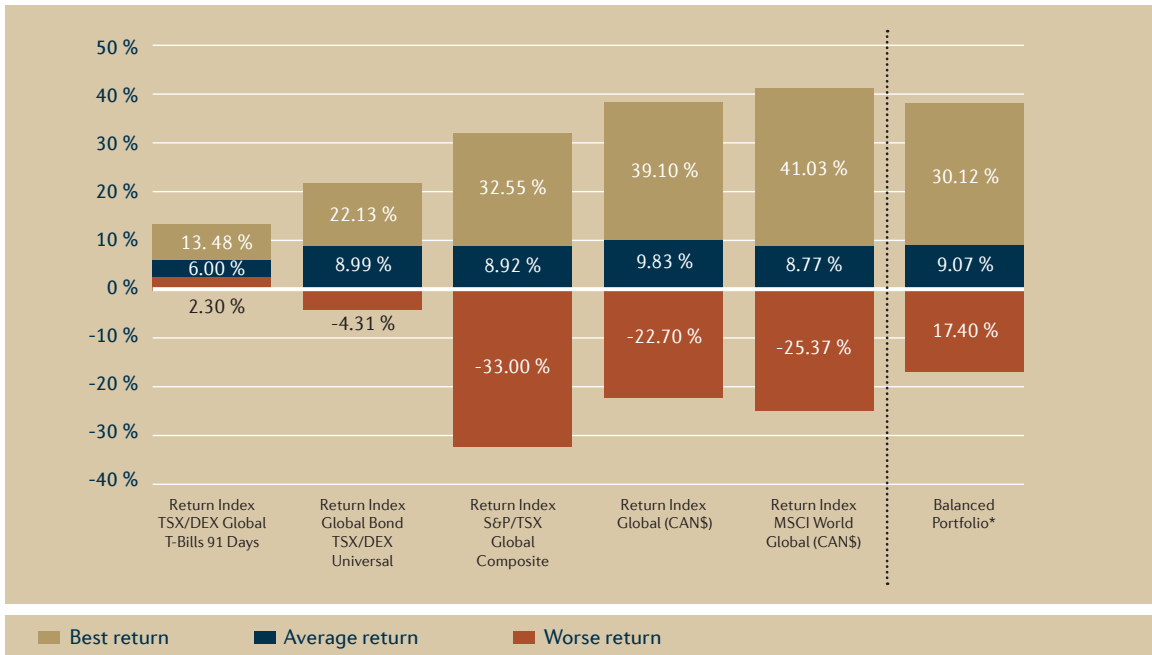
## Vary your asset classes

Diversification by asset class is the building block of any investment strategy. The principle is simple: by selecting several asset classes, investors can reduce their dependence on a single market or financial product. For example, if you only hold stocks and there is a stock market slowdown, your situation will be much less stable than if you had also invested in other types of investments such as bonds or term deposits.

Your portfolio should be made up of a varied proportion, based on your investor profile, of the major asset classes including cash holdings, fixed-income investments and growth securities (stocks). However, it is your investor profile that determines the portion that each type of investment should represent in your portfolio.

<sup>1</sup> H.M. Markowitz, winner of the 1990 Nobel Prize for economics.

## MAIN INDEXES - ANNUAL RETURN (1986 TO 2008)



\* 45% TSX/DEX Universal Bond; 25% S&P/TSX; 15% S&P 500; 15% MSCI World  
Source: Morningstar

## Invest in several geographic regions

A geographically well-diversified portfolio reduces the dependence of your investments on the Canadian economy and markets. Stock markets do not always move in lockstep. For example, Canadian and North American markets could stagnate at the same time as European, Asian or other markets experience strong growth. Investing in securities or products that invest in foreign markets is therefore an excellent way of diversifying your investments and balancing your portfolio.

Did you know that ...

### Canada represents only approximately 3%\* of world's market capitalization?

By limiting your investments to Canada, you lose out on contributions from significant economic forces and the possibility of major gains. It is therefore a good idea to add foreign content to your portfolio, without, however, overlooking opportunities at home.

\* Source: Bloomberg December 31, 2008.

## 1986 - 2008 - ANNUAL RETURNS OF MAJOR INDICES

| 1986  | 1987  | 1988  | 1989  | 1990   | 1991  | 1992  | 1993  | 1994  | 1995  | 1996  | 1997  | 1998   | 1999  | 2000   | 2001   | 2002   | 2003  | 2004  | 2005  | 2006  | 2007   | 2008   |
|-------|-------|-------|-------|--------|-------|-------|-------|-------|-------|-------|-------|--------|-------|--------|--------|--------|-------|-------|-------|-------|--------|--------|
| 67.96 | 17.57 | 28.67 | 60.10 | 13.48  | 59.30 | 22.41 | 82.30 | 14.23 | 33.90 | 28.35 | 39.10 | 37.70  | 57.23 | 10.24  | 8.08   | 8.73   | 27.83 | 16.78 | 31.17 | 32.08 | 18.55  | 6.41   |
| 41.03 | 10.08 | 17.92 | 27.80 | 7.54   | 30.00 | 18.30 | 38.95 | 11.86 | 20.67 | 23.40 | 21.35 | 33.95  | 31.71 | 7.41   | 4.72   | 2.52   | 26.72 | 14.48 | 24.13 | 26.37 | 9.83   | 3.33   |
| 17.10 | 8.47  | 13.57 | 21.37 | -2.90  | 22.13 | 9.84  | 32.55 | 7.40  | 17.96 | 14.56 | 14.98 | 29.16  | 20.28 | 5.49   | 3.63   | -6.97  | 13.84 | 11.91 | 11.16 | 20.19 | 4.43   | -21.20 |
| 14.70 | 5.88  | 11.08 | 13.74 | -10.39 | 18.52 | 7.08  | 28.38 | 5.35  | 14.53 | 12.26 | 9.63  | 9.18   | 18.44 | -5.50  | -6.40  | -12.44 | 9.41  | 7.15  | 7.27  | 17.26 | 3.68   | -25.37 |
| 9.33  | 4.04  | 9.79  | 12.81 | -14.80 | 12.21 | 4.76  | 18.14 | -0.18 | 8.41  | 6.93  | 6.56  | 4.79   | 14.20 | -9.89  | -11.28 | -16.53 | 6.69  | 6.85  | 6.46  | 15.35 | -5.32  | -28.78 |
| 8.95  | -0.90 | 9.41  | 12.36 | -16.37 | 12.02 | -1.43 | 14.70 | -1.81 | 7.39  | 6.56  | 3.15  | -1.58  | 4.66  | -10.95 | -12.57 | -20.37 | 5.26  | 2.81  | 2.58  | 4.06  | -7.08  | -33.00 |
|       |       | 7.00  | 7.66  | -23.10 | 9.83  | -3.25 | 5.51  | -4.31 | -7.83 | 5.02  | -7.69 | -19.86 | -1.14 | -28.19 | -16.51 | -22.70 | 2.91  | 2.30  | 2.29  | 3.98  | -10.53 | -41.44 |

- S&P/TSX Composite TR
- MSCI Europe, Asia, and Far East (EAFE) TR in CAD
- S&P 500 TR in CAD
- TSX DEX Universe Bond
- MSCI World TR in CAD
- TSX DEX Canadian 91 Day T-Bill
- MSCI Emerging Markets in CAD

Source: Bloomberg

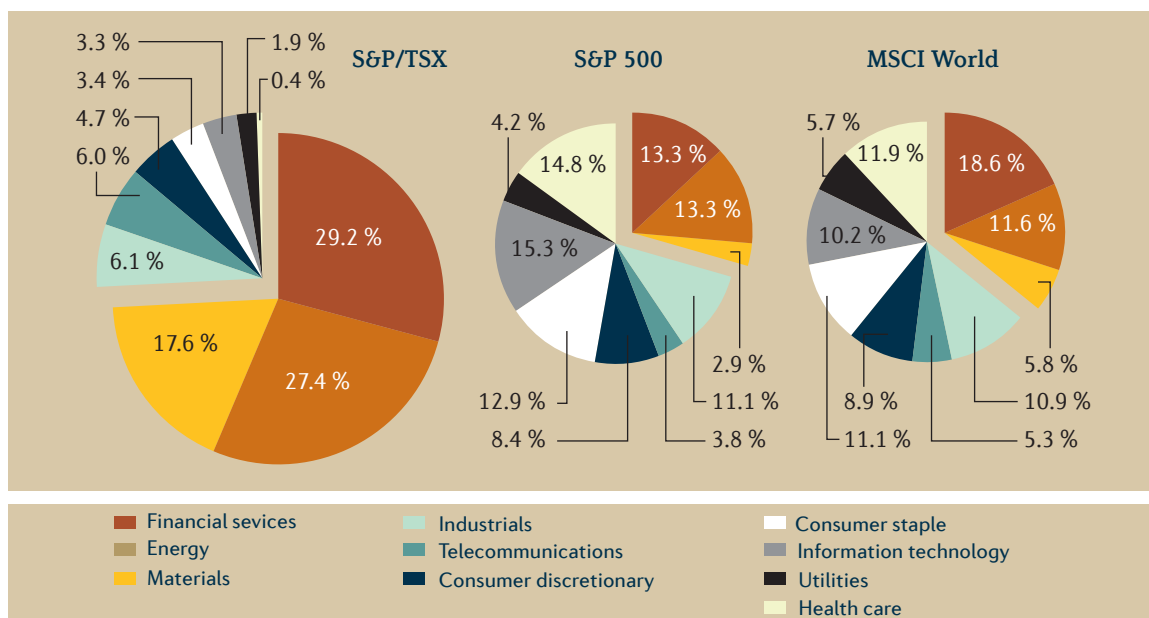
## Spread out your assets across several industries

By selecting investments in different industries, you benefit from another type of diversification that allows you to enhance your portfolio and reduce risks in the event of an economic slowdown in a particular sector.

For example, during a given period, natural resources may offer opportunities for appealing returns while the information technology sector is producing less stellar results. The opposite situation may then occur. Changes sometimes take place so quickly that no one can predict what will happen in the stock market. It is therefore crucial to diversify your portfolio across several industries so that you can take advantage of increases in certain sectors and reduce your exposure to decreases in others.

In 2008, more than 70% of the Canadian market was concentrated in just three sectors: Energy, Materials and Financials<sup>2</sup>.

## CANADA'S STOCK MARKET COMPARED TO THE U.S. AND THE WORLD IN TERMS OF SECTOR WEIGHTINGS (ACCORDING TO GLOBAL INDUSTRY CLASSIFICATION STANDARD, 2008)



Source: World Federation of Exchanges 2008

<sup>2</sup> S&P/TSX composite index as at December 31, 2008.

## Management styles

Financial journalists often refer to the different management styles used by stock portfolio managers: bottom-up or top-down, growth or value and finally momentum. Depending on the economic climate, some styles perform better than others, which can also have an impact on your portfolio.

Let's take a closer look at two of those styles.

### Value

- Low price/earnings ratio
- Low price/book value ratio
- Low price/cash flow ratio

Managers using a value approach try to buy shares worth \$1 for \$0.50

### Growth

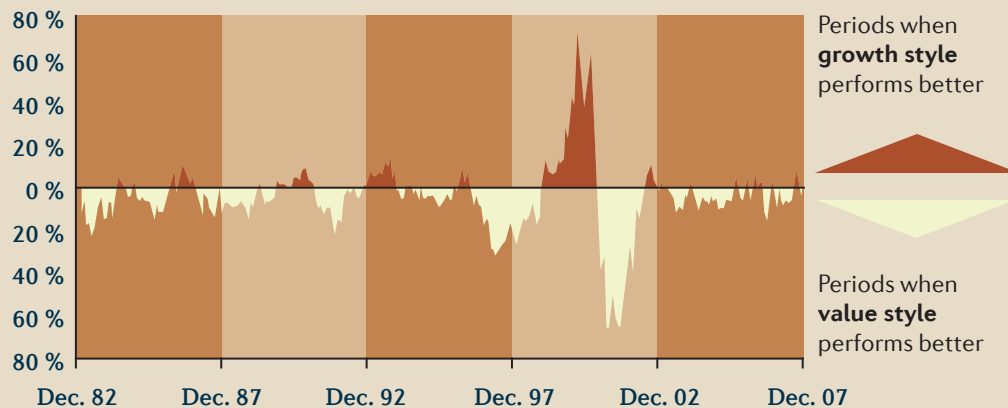
- High price/earnings ratio
- High price/book value ratio
- High price/cash flow ratio

Managers using this style are prepared to pay a higher price in exchange for future earnings, as the stocks they purchase have an above-average growth outlook.

### Performance of the two styles

- The value style generally performs better during market downturns (2001-2002)
- The growth style typically performs better when markets rise significantly (1998-2000)
- Differences in performance between the two styles can be dramatic; building a portfolio with a properly diversified management approach should help to minimize this risk.

### DIFFERENCE IN PERFORMANCE BETWEEN THE MSCI BARRA CANADA GROWTH & VALUE (1982-2007)

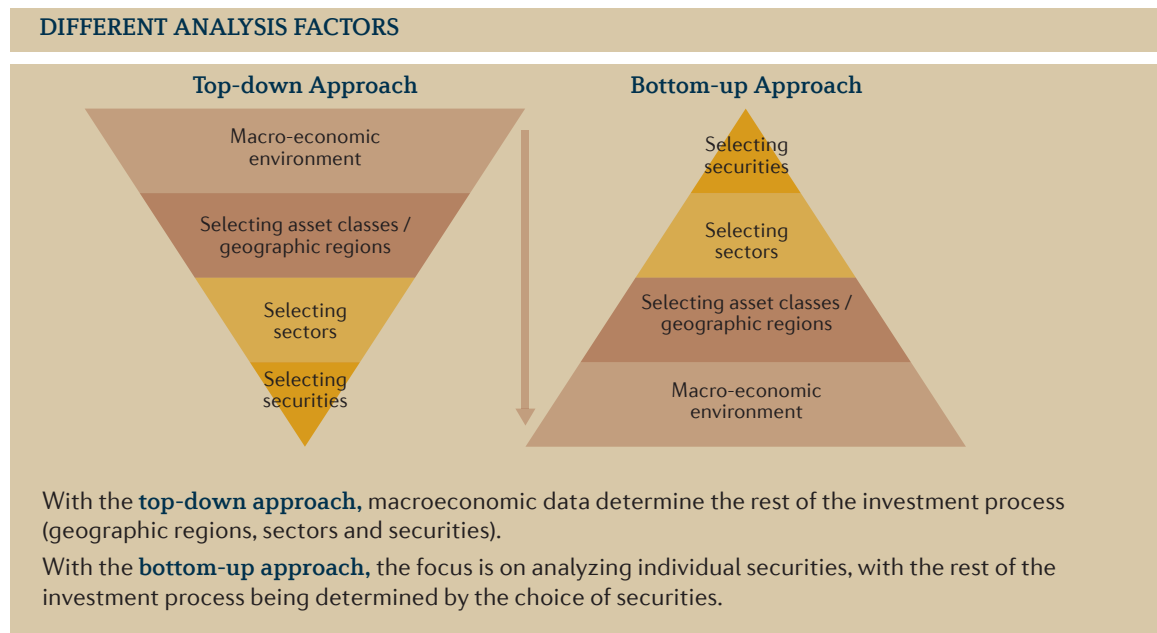


The difference in performance is represented by the difference in performance between the MSCI Barra Canada Growth Index and the MSCI Barra Canada Value Index over a 12-month period. Source: MSCI Barra

Over short periods, the growth style may significantly outperform the value style. However, over the long term, the value style is generally the dominant one. It is difficult to pinpoint which style will perform the best over a given period. This represents a risk if your portfolio is only made up of one of the two management styles.

## Two main management approaches

In addition to a management style, managers also select that is either a bottom-up or top-down management approach. Regardless of the approach, the managers take the same factors into account. It is the importance assigned to these factors that differs substantially from one approach to the other.



## Conclusion :

Each management style has its own characteristics. Diversification covers asset classes, geographic regions and sectors as well as management styles.

The challenge is to find an optimal mix based on your investor profile. At National Bank Financial Group, our advisors can propose investment solutions suited to your needs. Contact us.

## Useful Links

Investment solutions geared to your needs!:

[http://www.nbc.ca/bnc/files/bncpdf/en/2/e\\_c\\_pl\\_brochure\\_fonds.pdf](http://www.nbc.ca/bnc/files/bncpdf/en/2/e_c_pl_brochure_fonds.pdf)

Harry Markowitz:

[http://en.wikipedia.org/wiki/Harry\\_Markowitz](http://en.wikipedia.org/wiki/Harry_Markowitz)

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