FUND SPOTLIGHT

International Equity and Emerging Markets Equity Funds.

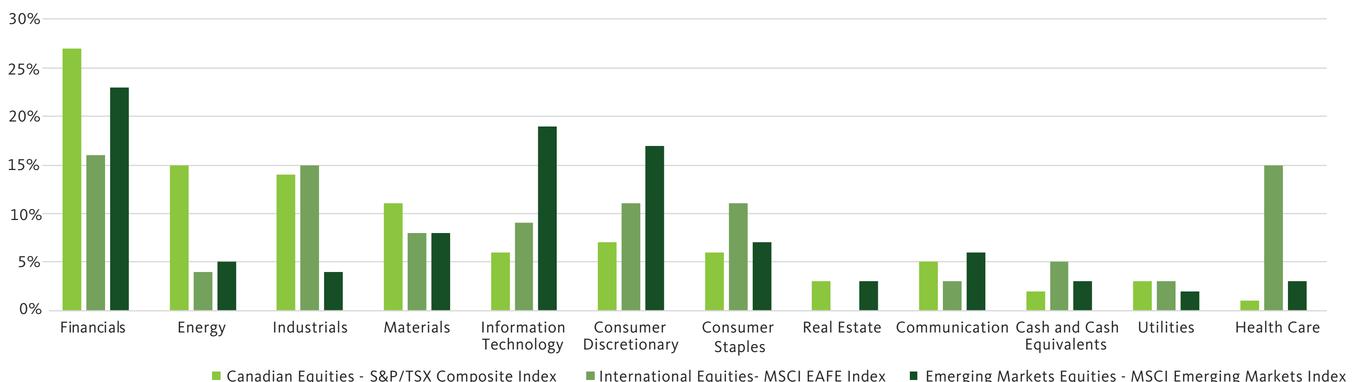
Why Foreign Equities

Continued globalization of the world economy is a multi-decade trend. Certainly, it can be impeded by high-profile events like Brexit, tit-for-tat tariffs in trade wars and the COVID-19 pandemic. Still, in the long term, this trend is not likely to go away. Most investors are familiar with economic globalization, but may be resistant to globalizing their portfolios. Due to what's known as home-country bias, investors around the world tend to put the majority of their assets in domestic holdings.

While home-country bias is prevalent everywhere, it can be particularly glaring in Canada. The MSCI ACWI Index is composed of over 2,900 constituents from 23 developed markets and 24 emerging markets. It represents approximately 85% of the free float-adjusted market capitalization in each country, and is well known and widely used for global equity comparisons. Even though Canada comprises only about 3% of the MSCI ACWI Index, most Canadian investors dedicate significantly more than 3% of their equity weight to domestic equities. While these investors may diversify across sectors within Canadian equities, they lack in diversified global equity exposures.

International equities play an important role in a well-diversified total portfolio. While Canadian equities are a key holding for investors seeking capital growth, they largely share the same set of macroeconomic, regulatory and industry exposures. From this perspective, they do not offer optimal diversification—instead, they are concentrated in many of the same risk exposures. For instance, the Canadian equity market (represented by the S&P/TSX Composite Index "Canada Index") is focused in a few highly cyclical sectors, with nearly one-third of its weight in financials and roughly one-quarter shared between energy and materials (see Exhibit 1).

Exhibit 1: Sector allocations across indexes



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Source: SEI. Data as of 12/31/2022. Website used for classification - msci.com/acwi

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Investors can diversify these risks substantially by including stocks from the EAFE (Europe, Australasia, and the Far East). Stocks in these regions are generally exposed to different economic and geopolitical factors compared to Canadian-domiciled equities, affording a greater degree of diversification with regard to sources of risk. Just as importantly, allocating to the EAFE equity market offers the opportunity for more balanced sector and industry exposures. As compared to Canadian markets, financials constitute a much smaller portion of the MSCI EAFE Index ("EAFE Index") at roughly 16%, and energy and materials combine to account for only about 12% (see Exhibit 1). Sectors such as health care and consumer staples, which are not present or only modestly present in the Canadian market, are meaningful components of the EAFE Index. Therefore, allocating to the EAFE Index can help broaden sector and industry exposures of a portfolio's equity sleeve—thereby helping to limit the portfolio's vulnerability to shocks from a single segment of the market. This should give investors more confidence in the ability of their portfolios to meet their financial goals.

Similarly, investors can further improve sector diversification by including emerging market equities in their portfolios. The MSCI Emerging Markets Index information technology weight is more than double that of the MSCI EAFE Index and the Canada Index (Exhibit 1). And it doesn't stop at sector diversification either. There are value and growth components as well since emerging market equities historically trade at a discount to developed markets and offer higher growth rates.

Why SEI International and Emerging Markets Equity Funds?

Manager of managers

Manager-of-managers strategies combine multiple third-party manager strategies into a single mutual fund with the expectation that specialization should have a beneficial bearing on performance. Given there are varying ways to analyze an opportunity set, SEI seeks specialists with unique expertise to work collectively under our watch to harvest opportunities. In the equity space, this allows us to diversify by alpha sources—or, in more common terms, drivers of excess return.

Alpha sources

We believe our alpha-source framework differentiates SEI from competitors. Within equity, we have four primary alpha sources—and we diversify our sub-advisors by alpha source or factors.

Value: Seeks to benefit from market mispricing and mean reversion in underlying **sectors**, **industries** and **currencies** that manifest due to investor overreactions and loss aversion.

Momentum: Follows trends in order to acquire assets with recently **improved price**, **earnings**, or other relevant factors.

Quality: Maintains a long-term buy-and-hold strategy to acquire assets with **outstanding and stable profitability**, as well as have **high barriers of entry**.

Selection: Seeks to uncover **idiosyncratic opportunities** that have been mispriced by other financial market participants.

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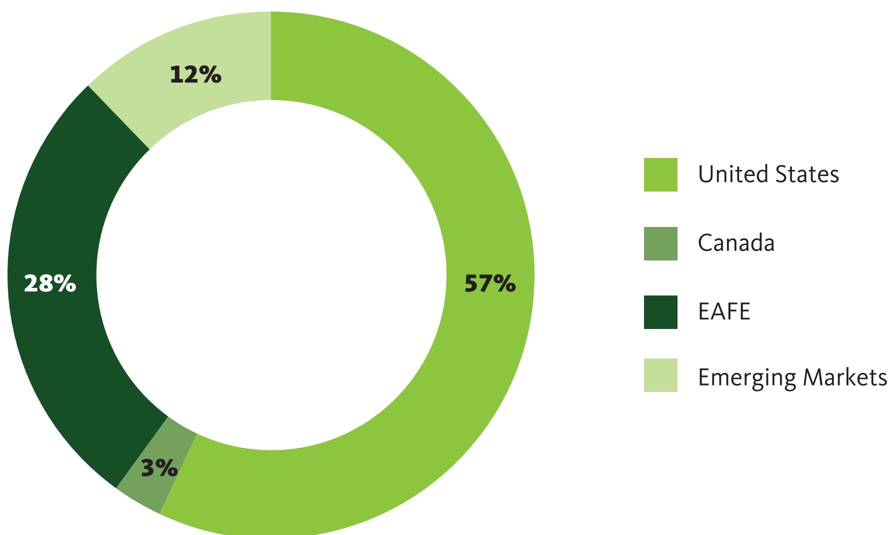
Suggested implementation

Foreign equities have a place in most strategies

Although allocations vary over time, EAFE equities typically comprise over 20% of the MSCI ACWI Index on a capitalization-weighted basis. Emerging markets, meanwhile, comprise less than 20% of the ACWI Index. In terms of the share of global market capitalization alone, we think it is clear that these securities should have a place in most equity allocations. As previously noted, they also diversify from a sector perspective.

Exhibit 2: Global equity allocations



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Add risk in order to decrease risk

Foreign equities often carry more risk than an investor's domestic equities. Much of this is due to the addition of currency risk. Emerging markets generally have less stable currencies and a host of other risks, including potential political instability and economic concerns (labour issues, raw-materials shortages, unstable inflation, unregulated markets, to name a few). However, even though these asset classes are riskier on a stand-alone basis, they are not perfectly correlated with Canadian equities. Adding noncorrelated assets to a portfolio, even those that are riskier, can lower the overall risk of the total portfolio.

Home-country bias is difficult to avoid

In a perfect world, investors would have little to no home-country bias. In the real world, it's nearly unavoidable; we recognize that most investors will have (and may even prefer) an overweight to domestic equities. Given this, it's likely that many Canadian investors will allocate significant capital to U.S. equities (which typically comprise over half of the ACWI Index) and Canadian equities. But that still leaves room for a meaningful allocation to equities outside of North America. The total size of this allocation will obviously vary by investor and risk tolerance, but an allocation of approximately 75-80% EAFE equities and 20-25% emerging markets would capture the relative prominence of the regions.

To learn how to add SEI's International Equity and Emerging Markets Equity Funds to your clients' portfolios, contact your relationship manager.

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