

# Myths, misconceptions and international investing

Presenter: Donald. G. Bennyhoff, CFA  
Vanguard Investment Strategy Group

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# Agenda

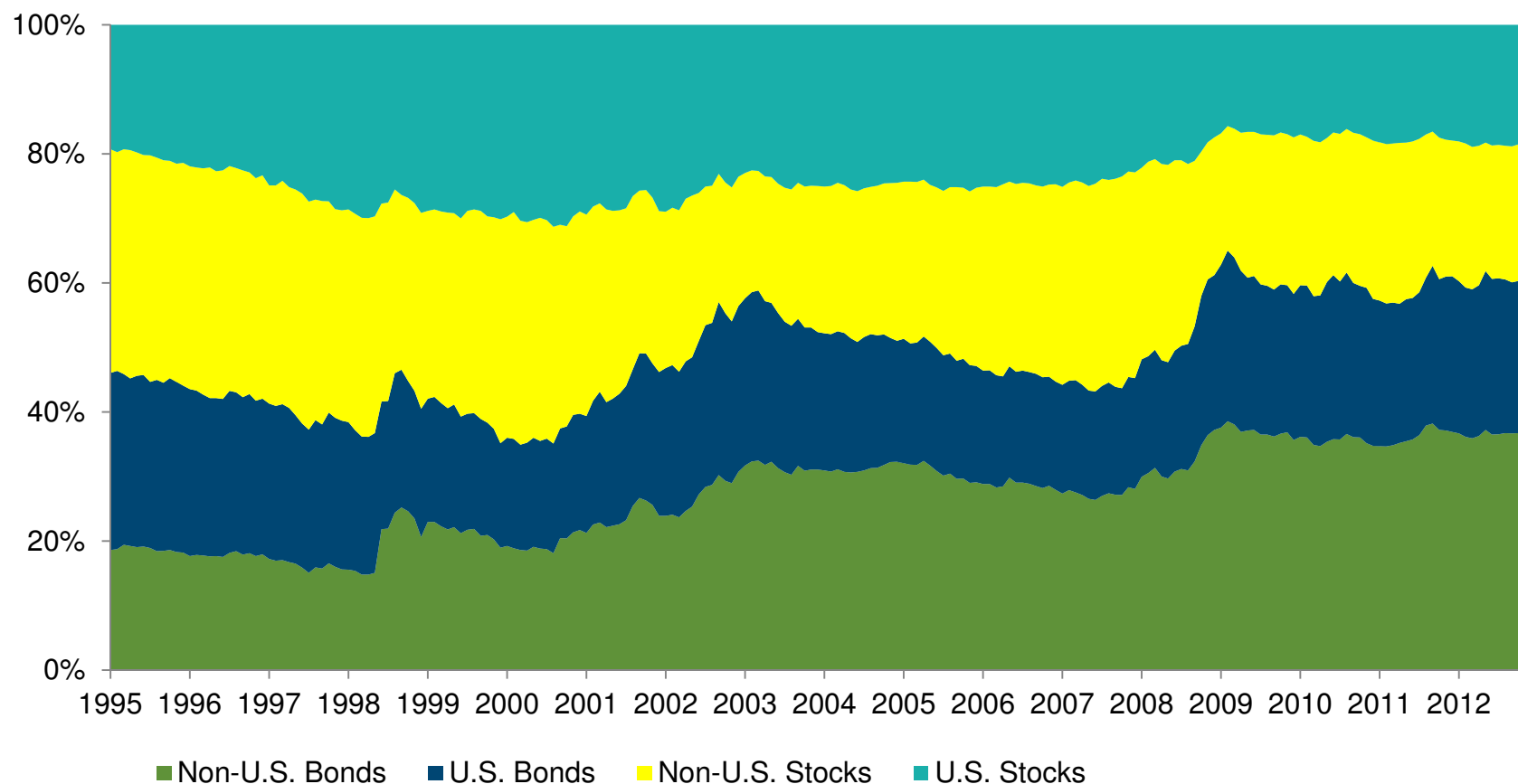
Global investable markets

Comfort food: Home cooking and home bias

Diversification:  
Alive and kicking

Implementing an international strategy

# Global investable market components: 1995-2012

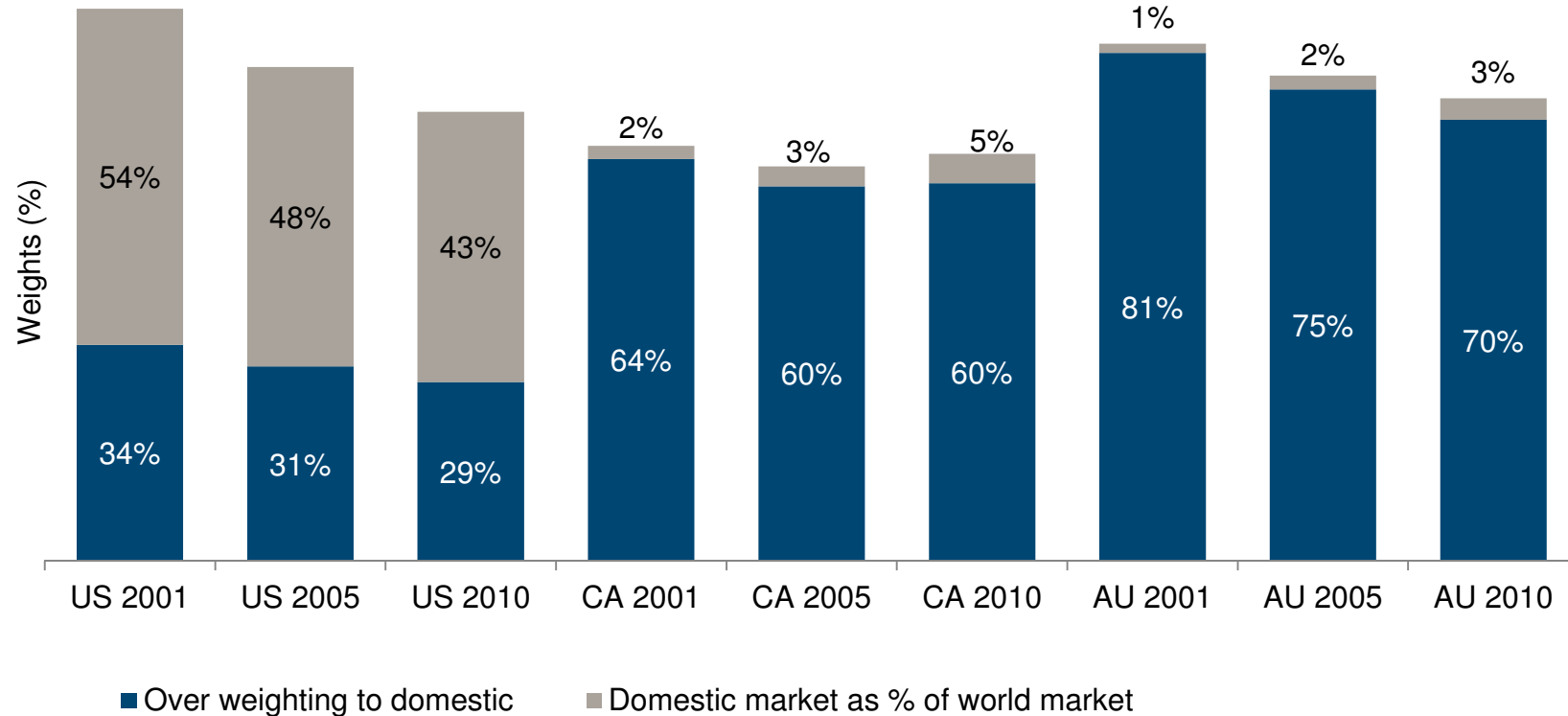


Notes: Non-U.S. bonds are represented by the Barclays Global Aggregate ex-USD Bond Index through 12/31/2000 and by that index plus the Barclays Global Emerging Markets Index thereafter. U.S. bonds are represented by the Barclays U.S. Aggregate Bond Index. U.S. stocks are represented by the MSCI USA Index. Non-U.S. stocks are represented by the MSCI All Country World ex USA Index.

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# Home bias

## The evolution of equity home bias

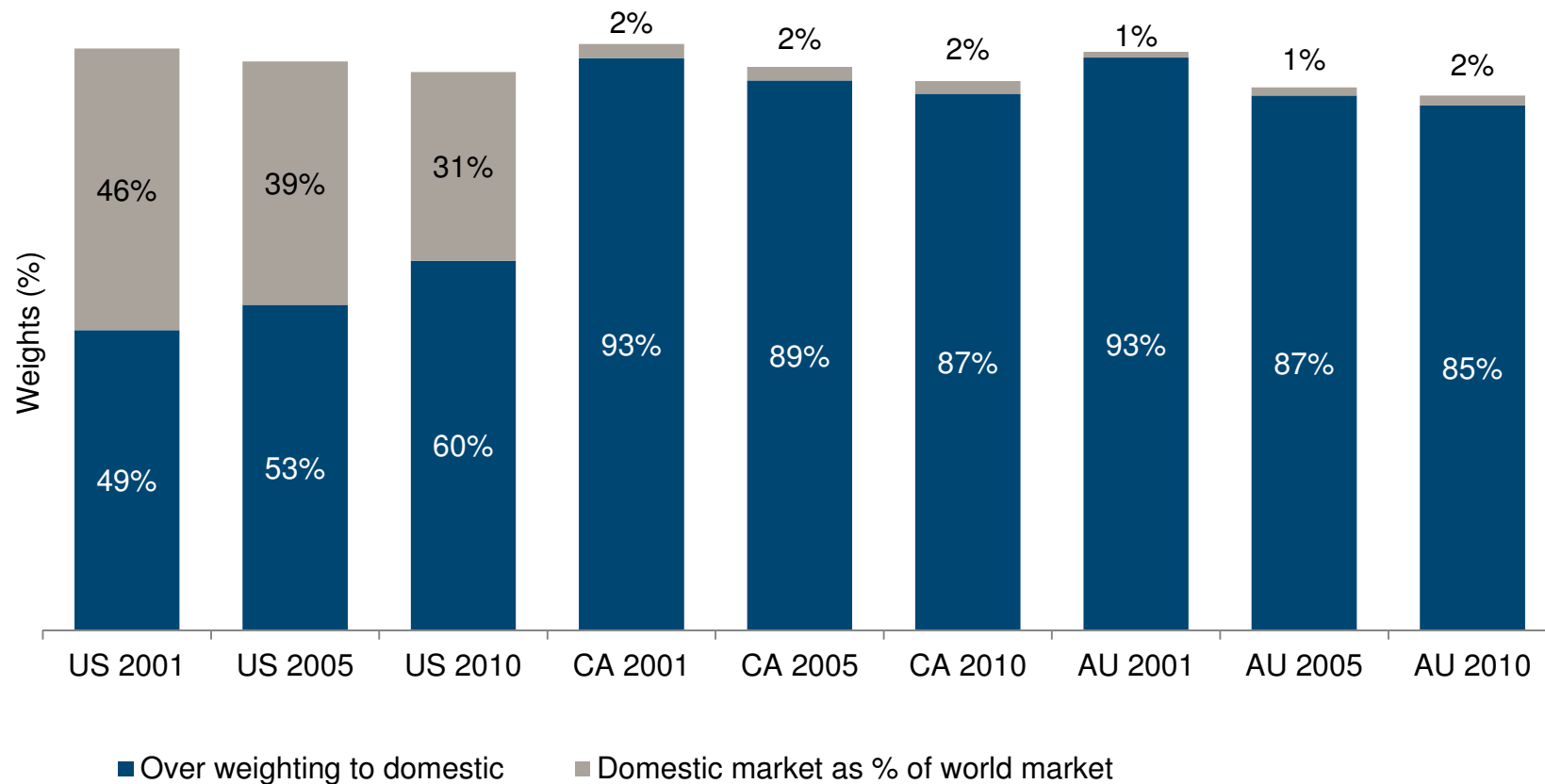


Source: International Monetary Fund Coordinated Portfolio Investment Survey, Barclays and Thomson Reuters Datastream.

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# Home bias

The evolution of fixed income home bias

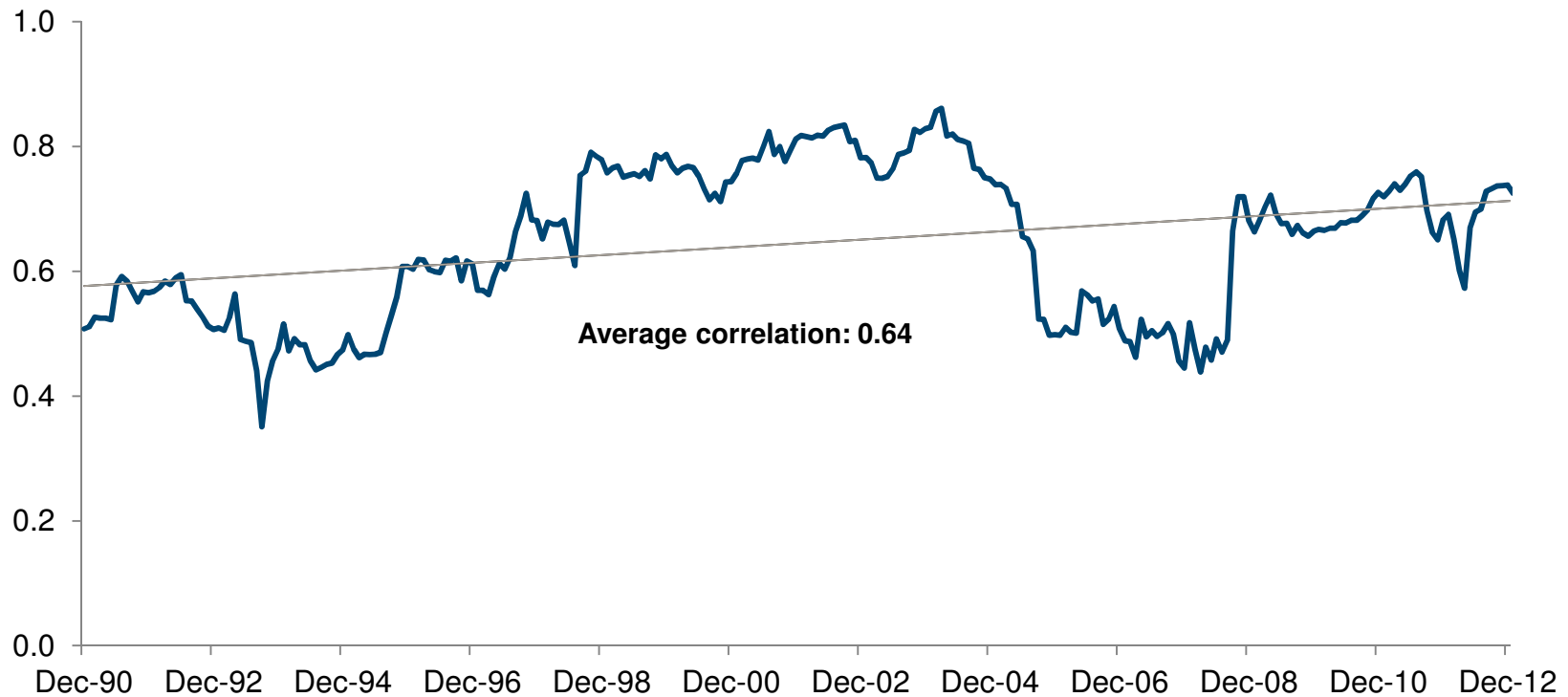


Source: International Monetary Fund Coordinated Portfolio Investment Survey, Barclays and Thomson Reuters Datastream.

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# Myth: Correlations are high, benefits are low Reality: International diversification is still/always relevant

## Rolling 36-month correlations – Canadian and world ex- Canada equities



Source: Vanguard calculations using Thomson Reuters DataStream.

Note: Domestic returns are represented by the MSCI Canada Index. Because a comprehensive index for global equities ex Canada is not available from Thomson Reuters, we backed into the index by splicing the MSCI EAFE index (\$C) with the MSCI Emerging Markets Index (\$C) and the MSCI USA Index (\$C). All returns denominated in the domestic country currency.

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# The home bias 'bias'

## Industry and security concentration is common

Sectors	Sector differences (%) vs. ACWI IMI	
	MSCI Canada IMI	MSCI USA IMI
Consumer discretionary	-6.44	0.9
Consumer staples	-7.44	0.3
Energy	<b>14.28</b>	0.1
Financials	<b>14.18</b>	-4.1
Health care	<b>-8.37</b>	2.6
Industrials	-4.98	-0.3
Information technology	<b>-10.7</b>	6.4
Materials	<b>14.07</b>	-4.3
Telecommunication services	-1.91	-1.6
Utilities	-2.69	0.01

Source: Vanguard calculations based on FactSet data. Data as of December 31, 2011.

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# The home bias 'bias'

## Industry and security concentration is common

Measures of concentration (as of December 31, 2012)

	MSCI USA IMI		MSCI UK IMI		MSCI Canada IMI		MSCI World IMI	
<b>Number of securities</b>	2,470		357		339		5,895	
<b>Percentage in top-10 holdings</b>	16		39		34		9	
<b>Top-5 stocks</b>	Apple Inc.	3.20%	HSBC Holdings	6.90%	Royal Bank of Canada	5.92%	<b>Apple Inc.</b>	<b>1.70%</b>
	Exxon Mobil	2.57%	BP	4.71%	Toronto-Dominion Bank	5.24%	<b>Exxon Mobil</b>	<b>1.36%</b>
	GE	1.42%	Royal Dutch Shell	4.59%	Bank of Nova Scotia	4.50%	<b>GE</b>	<b>0.75%</b>
	Chevron Corp.	1.36%	Vodafone Group	4.42%	Suncor Energy Inc.	3.46%	<b>Chevron Corp.</b>	<b>0.72%</b>
	IBM Corp.	1.34%	GlaxoSmith Kline	3.87%	Bank of Montreal	2.69%	<b>Nestle S.A.</b>	<b>0.71%</b>

Source: Vanguard calculations using FactSet.

For illustrative purposes only. The examples of underlying securities should not be construed as a recommendation to buy, hold or sell the securities.

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# International diversification in practice

## Costs: Control the controllable

Asset-weighted MERs for funds offered in Canada (as of December 31, 2012)

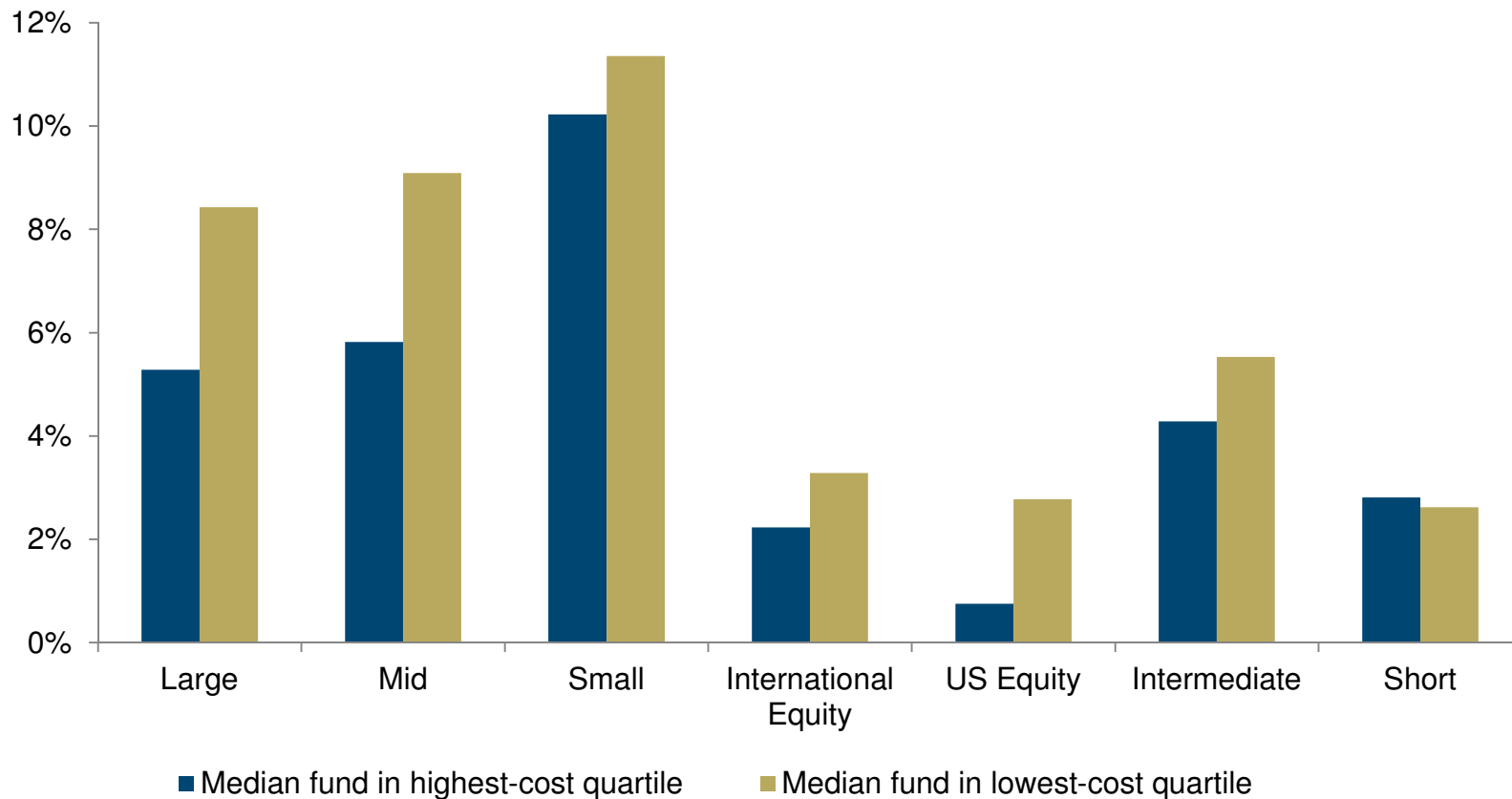
Category	Active funds	Index funds	Difference
Canadian equity	2.22	0.85	1.37
International equity	2.07	1.10	0.98
U.S. equity	2.22	0.84	1.38
Fixed income	1.37	0.75	0.61

Source: Vanguard calculations using asset-weighted management expense ratios compiled from prospectuses by Morningstar, Inc. Data as of December 31, 2012. Cost comparisons are for illustrative purposes only and are not meant to be all-inclusive. MER is calculated as the total fees and expenses charged over the previous 12-month period. MER is expressed as an annual percentage of fund assets. It is composed of the base management fee plus certain operating expenses, such as administrative costs, plus applicable taxes. Transaction costs associated with the issue, exchange, sale and redemption of funds are not included. Trading, portfolio rebalancing, optional costs and income taxes payable by any unit-holder, are also not included. Different components contribute to the respective MER calculations for actively managed funds and index funds. MERs may not reflect management fee waivers or operating expense absorptions. There may be significant differences between the investments that are not discussed here including different objectives and risk factors.

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# Myth: You get what you pay for Reality: Gross return, less costs, equals net returns

Canadian mutual fund performance – 10 years ended 12/31/2012



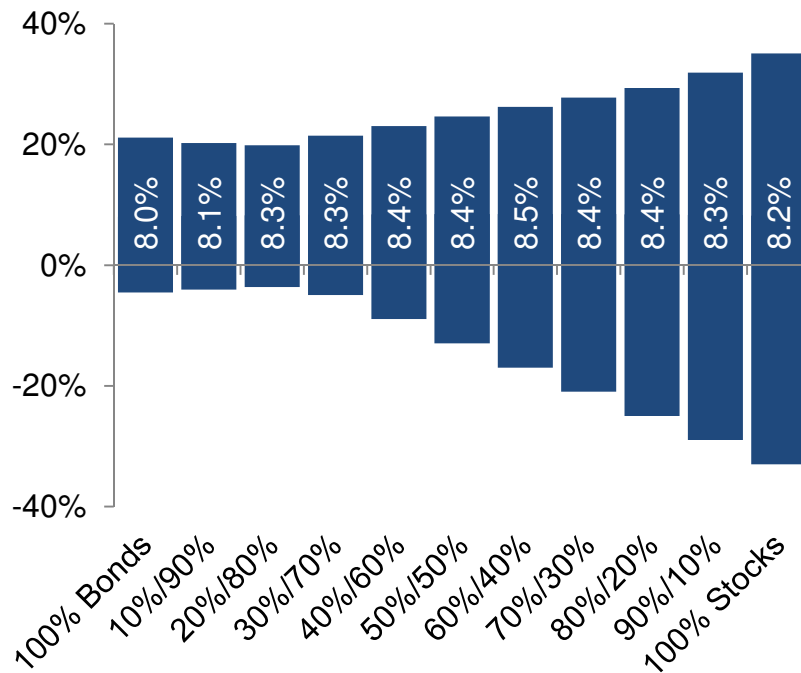
Sources: Vanguard calculations, using data from Morningstar, Inc.

Transaction costs associated with the issue, exchange, sale and redemption of funds are not included. Trading, portfolio rebalancing, optional costs and income taxes payable by any unit-holder are also not included.

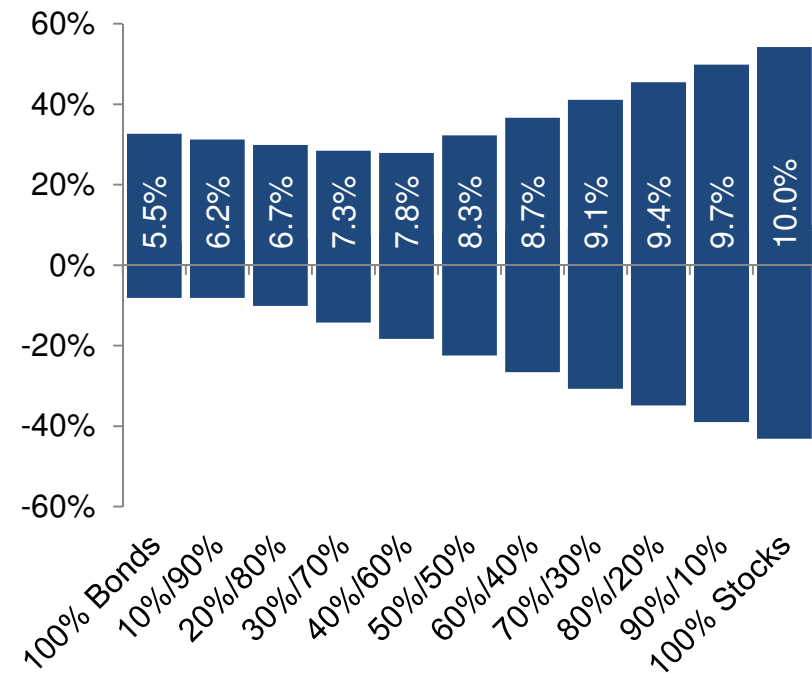
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# Risk and reward are interrelated Unless they're not... Use data with care

Historical range of annual returns for Canadian asset allocations (1984-2012)



Historical range of annual returns for U.S. asset allocations (1926-2012)



Source: Thomson Datastream and Vanguard

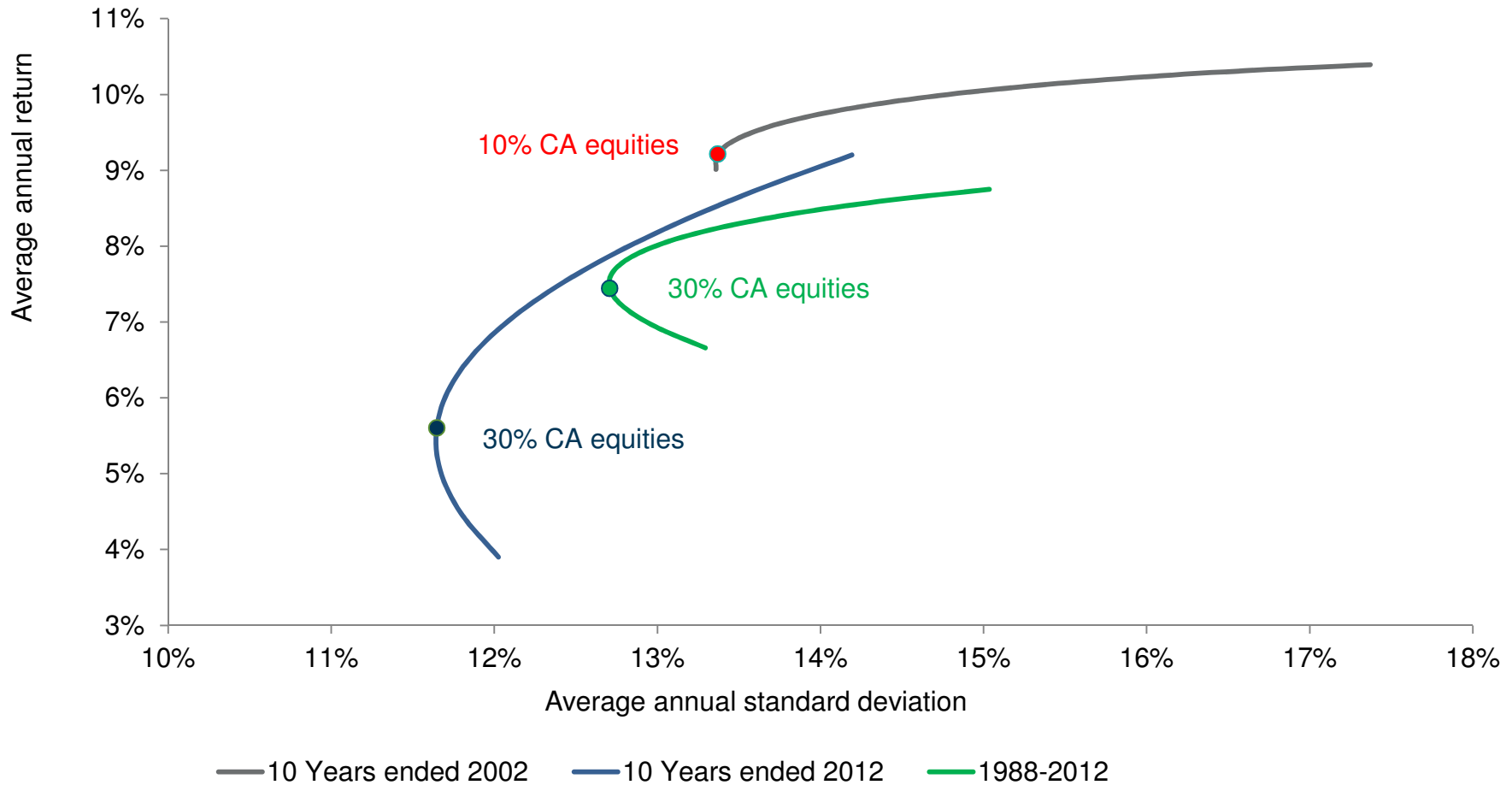
**Canadian data:** Equities represented by S&P/TSX Composite Index – Total Return. Bonds represented by Citi WGBI All Maturities through 2001 and Barclays Canadian Issues 300MM thereafter.

**U.S. data:** Stocks are represented by the S&P 90 Index from 1926 to 3/3/1957, the S&P 500 Index from 3/4/1957 through 1974; the Wilshire 5000 Index from 1975 through April 22, 2005; and the MSCI US Broad Market Index thereafter. Bonds are represented by the Standard and Poor's High Grade Corporate Index from 1926 to 1968, the Citigroup High Grade Index from 1969 to 1972, the Barclays U.S. Long Credit AA Index 1973 to 1975, and the Barclays Capital U.S. Aggregate Bond Index thereafter.

**Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.**

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# History is a guide, not a rule



Source: Vanguard calculations using Thomson Reuters DataStream.

Note: Domestic returns are represented by the MSCI Canada Index. Because a comprehensive index for global equities ex Canada is not available from Thomson Reuters, we backed into the index by splicing the MSCI EAFE index (\$C) with the MSCI Emerging Markets Index (\$C) and the MSCI USA Index (\$C). All returns denominated in the domestic country currency. The returns reflect the reinvestment of distributions and dividends, but do not reflect fees, transaction costs or other expenses, which would have reduced returns.

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# Diversification: Because we don't know the future

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
S&P/TSX Smallcap 34.35%	MSCI ACWI Real Estate 26.79%	MSCI EM 31.17%	MSCI ACWI Real Estate 41.46%	MSCI EM 18.55%	Citi WGBI Canada All Mat. 12.00%	S&P/TSX Smallcap 62.38%	S&P/TSX Smallcap 35.10%	Barclays Canadian 300 10.00%	MSCI ACWI Real Estate 28.53%
MSCI EM 27.83%	MSCI EM 16.78%	S&P/TSX 24.13%	MSCI EM 32.08%	S&P/TSX 9.83%	Barclays Canadian 300 7.10%	MSCI EM 52.03%	S&P/TSX 17.61%	Barclays EM Bond 9.62%	MSCI EM 16.00%
S&P/TSX 26.72%	S&P/TSX 14.48%	DJ UBS Commodity 18.32%	MSCI EAFE 26.38%	Citi WGBI Canada All Mat. 5.02%	Barclays EM Bond 6.63%	S&P/TSX 35.05%	MSCI EM 12.97%	Citi WGBI Canada All Mat. 9.54%	Barclays EM Bond 15.33%
MSCI EAFE 13.83%	MSCI EAFE 11.91%	MSCI ACWI Real Estate 13.14%	S&P/TSX 17.26%	Barclays Global Agg. (Hedged) 4.51%	Barclays Global Agg. (Hedged) 5.73%	MSCI ACWI Real Estate 14.72%	MSCI ACWI Real Estate 12.39%	Barclays Global Agg. (Hedged) 6.33%	MSCI EAFE 15.28%
MSCI ACWI Real Estate 12.84%	Barclays Canadian 300 7.26%	MSCI EAFE 11.16%	S&P/TSX Smallcap 11.61%	Barclays Canadian 300 3.96%	DJ UBS Commodity -19.51%	Barclays EM Bond 13.99%	DJ UBS Commodity 10.73%	MSCI ACWI Real Estate -6.15%	S&P/TSX 7.19%
Barclays Canadian 300 6.17%	Citi WGBI Canada All Mat. 7.01%	S&P/TSX Smallcap 10.60%	Barclays EM Bond 9.54%	S&P/TSX Smallcap 0.90%	MSCI EAFE -28.78%	MSCI EAFE 12.49%	Barclays EM Bond 6.95%	S&P/TSX -8.71%	Barclays Global Agg. (Hedged) 6.55%
Citi WGBI Canada All Mat. 5.61%	S&P/TSX Smallcap 6.50%	Barclays EM Bond 9.46%	Barclays Canadian 300 4.01%	DJ UBS Commodity -1.43%	S&P/TSX -33.00%	Barclays Global Agg. (Hedged) 5.04%	Barclays Canadian 300 6.88%	MSCI EAFE -9.55%	Barclays Canadian 300 3.27%
Barclays Global Agg. (Hedged) 4.72%	Barclays Global Agg. (Hedged) 5.71%	Barclays Canadian 300 7.07%	Citi WGBI Canada All Mat. 3.54%	MSCI EAFE -5.33%	MSCI ACWI Real Estate -36.55%	Barclays Canadian 300 3.62%	Citi WGBI Canada All Mat. 6.18%	DJ UBS Commodity -11.17%	Citi WGBI Canada All Mat. 2.19%
Barclays EM Bond 2.80%	Barclays EM Bond 3.76%	Citi WGBI Canada All Mat. 7.02%	Barclays Global Agg. (Hedged) 2.58%	Barclays EM Bond -10.81%	MSCI EM -41.44%	DJ UBS Commodity 0.98%	Barclays Global Agg. (Hedged) 5.04%	MSCI EM -16.15%	S&P/TSX Smallcap -2.23%
DJ UBS Commodity 1.37%	DJ UBS Commodity 1.20%	Barclays Global Agg. (Hedged) 3.69%	DJ UBS Commodity 1.68%	MSCI ACWI Real Estate -17.48%	S&P/TSX Smallcap -45.49%	Citi WGBI Canada All Mat. -1.71%	MSCI EAFE 2.56%	S&P/TSX Smallcap -16.43%	DJ UBS Commodity -3.25%

Source: Thomson Datastream and Vanguard.

The illustration is not intended to be relied upon in determining which ETFs to buy or sell or when to buy or sell such ETFs.

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# Myth: Use active in 'inefficient' markets Reality: Indexes are hard to beat, regardless

		Vs. prospectus			Vs. style		
		Percentage underperforming		Median surviving fund excess return	Percentage underperforming		Median surviving fund excess return
		Survivorship			Survivorship		
		Unadjusted	Adjusted		Unadjusted	Adjusted	
<b>Canadian equity:</b>	Large	74%	79%	<b>-2.26%</b>	87%	89%	<b>-2.01%</b>
	Mid	53%	60%	<b>-2.85%</b>	97%	98%	<b>-5.92%</b>
	Small	24%	36%	0.31%	50%	58%	0.35%
<b>Non-Canadian equity:</b>	International equity	80%	82%	<b>-1.37%</b>	86%	87%	<b>-1.65%</b>
	U.S. equity	59%	67%	<b>-1.15%</b>	72%	78%	<b>-1.85%</b>
<b>Fixed income:</b>	Intermediate	76%	80%	<b>-1.07%</b>	91%	92%	<b>-1.06%</b>
	Short	74%	77%	<b>-1.16%</b>	97%	97%	<b>-1.32%</b>

**Notes: Data for 10 years ended December 31, 2012.**

Sources: Vanguard calculations, using data from Morningstar, Inc. and Thomson Reuters Datastream. Equity benchmarks represented by the following indexes: Large — MSCI Canada Large-Cap Index; Mid — MSCI Canada Mid-Cap Index; Small — MSCI Canada Small-Cap Index. Bond benchmarks represented by the following Barclays indexes: Intermediate — Barclays Global Aggregate Canadian Float Adjusted Bond Index; Short — Barclays Global Aggregate Canadian Gov/Credit 1–5 year Float Adjusted Bond Index

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# Persistent outperformance is elusive

Analyzing persistence of ranking in actively managed U.S. funds

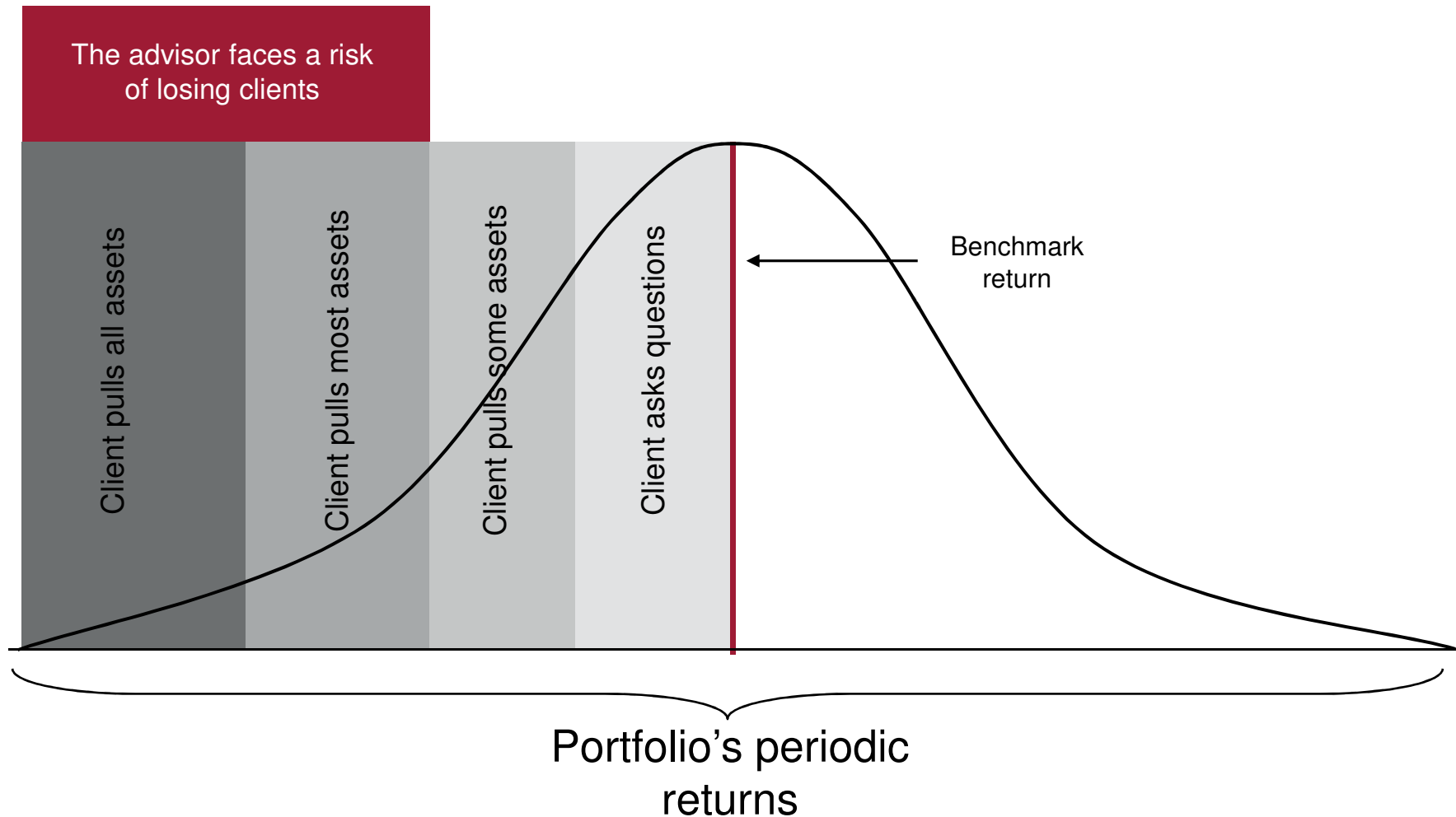
Excess return rank 5-year Ending Dec. 2007	Quintile rank in subsequent non-overlapping 5-year period (% of funds) Ending Dec. 2012						
	Highest quintile	High	Medium	Low	Lowest quintile	Missing	Total
Highest quintile (1)	4%	15%	11%	24%	24%	24%	100%
High (2)	28%	19%	19%	15%	13%	7%	100%
Medium (3)	35%	15%	16%	11%	16%	7%	100%
Low (4)	9%	30%	38%	8%	9%	6%	100%
Lowest quintile (5)	23%	17%	11%	17%	17%	15%	100%

Notes: The first two columns rank all active U.S. equity funds within each of the Morningstar style categories based on their excess returns relative to their stated benchmarks during the period cited. The shaded columns show how the funds in each quintile performed over the next five years.

Sources: Vanguard and Morningstar, Inc.

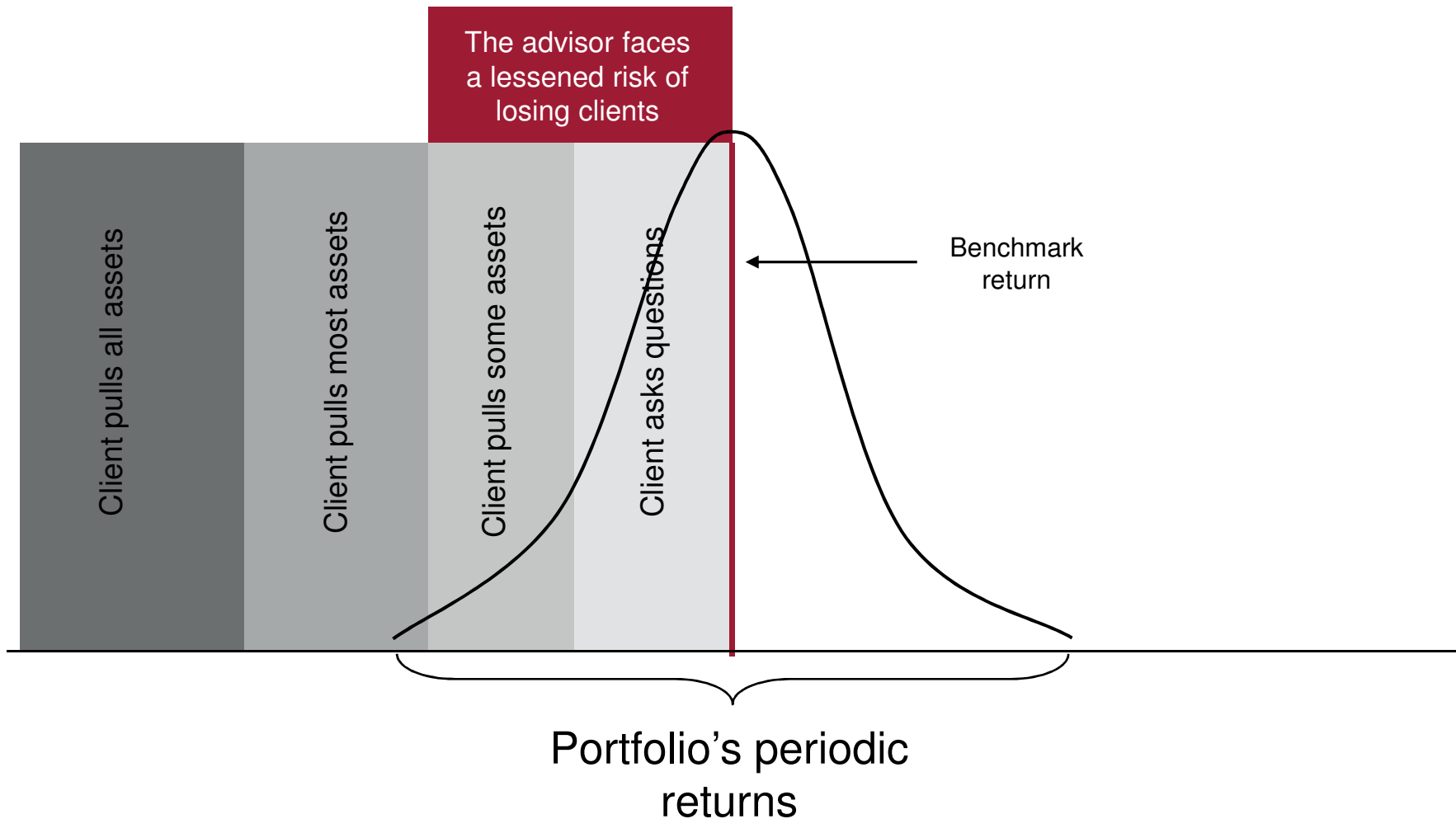
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# How will clients react when a strategy is out of favour?





# Adding a broad market index fund dilutes alpha, but can temper the drawdown



## Conclusion: Optimizing the odds of delivering client alpha

- Higher correlations do not require lower allocations to international
- Investment markets are always uncertain: DIVERSIFY
- Indexing can play a vital role in de-risking your business
- 'Staying the course' IS NOT 'set it and forget it'

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