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Watch your Portfolio Weighting

Here's an answer for your struggling Canadian stocks and equity funds: Buy American.

We have a monster weighting in commodities, the U.S. market does not. Our tech, health care and consumer products sectors are stunted, while the U.S. market is well-stocked. A quick summary of stock market action this year: Commodities down; health care, tech and consumer products up.

The best part of a Buy American strategy is that you don't need to spend a lot of time agonizing over the right investment. If you prefer exchange-traded funds, any product that tracks broad markets (as opposed to sectors) should work. If you prefer U.S. equity mutual funds, there are almost none that mirror the big energy and materials weighting of Canadian equity funds.

It wasn't long ago that many investors would scoff at the idea of having a significant weighting in U.S. stocks. With its commodity bias, the Canadian market outperformed U.S. stocks for years on end. Massive debts, a struggling economy and government gridlock cinched the decision to avoid the United States.

Last year, the U.S. stock market reasserted itself by rising a bit while the Canadian market fell sharply. Same thing this year. The S&P/TSX composite index (TSX-I11,553.80-12.27-0.11%)was off 5.2 per cent as of May 17, while the S&P 500 (SPX-I1,322.641.960.15%) was up 3.8 per cent (in U.S. dollars).

There are signs of economic recovery in the United States, and corporate earnings have improved. But what's really attractive about the U.S. market to Canadians is that it's rich in what we don't have, and poor in what we have in abundance.

Information technology is a great example. The sector accounts for 1.2 per cent of the S&P/TSX composite index; the two dominant companies are CGI Group (GIB.A-T20.73----%) and Research In Motion(RIM-T11.360.383.46%). Together, they make up about half of the S&P/TSX capped information technology index.

CGI, a technology outsourcing company, is a quiet success story in the tech field. The company's shares are up a cumulative 104 per cent in the past three years and in this year's tough markets they've risen 9.2 per cent. RIM, you know. Its shares are down 86 per cent over the past three years and 22 per cent this year alone. That's a big reason why the info tech index is down about 6 per cent this year.

The S&P information technology index (SP500IT-I449.33----%) in the U.S. market has climbed 11 per cent this year thanks to stocks like Apple, up 31 per cent; eBay, up 29 per cent; and Microsoft, up 14 per cent. In fact, tech is now the largest sector in the S&P 500 at 20 per cent.

Frankly, that seems like a heavy weighting for a sector as flighty as technology. But given the Canadian markets' near-zero exposure to tech, it's not like this sector is going to overrun your portfolio if you pair up funds that cover both the Canadian and U.S. markets.

It's worth highlighting that after tech, the dominant sectors in the S&P 500 are financials at just over 14 per cent and health care at almost 12 per cent. Our Canadian market is far more concentrated in its top three sectors. Financials, energy and materials add up to 75 per cent of the index.

The S&P 500 is often used as a proxy for the U.S. stock market, but it's actually an index of large companies and thus does not provide an accurate reading on the broader universe of large, medium and small companies. For that, a total market gauge like the MSCI U.S. Broad Market index is more useful. A sector breakdown for this broad market index shows tech at just under 20 per cent. It is followed by financials and consumer discretionary stocks. Energy and materials account for less than 15 per cent.

A definitive index for small U.S. stocks is the Russell 2000, where the combined energy and materials exposure gets squeezed down to about 13 per cent. The weightiest sector is financials at 25 per cent, which compares to 32 per cent for the S&P/TSX composite. A reasonable conclusion here is that pairing up U.S. small stocks with a broad index of Canadian market investments will result in financial sector overload.

An advantage of using an index of U.S. large stocks is that you get exposure to multinational companies that do not depend strictly on how the American economy does. You can get the same diversification benefits from global investing, of course.

The MSCI World index, a benchmark for global equity funds, has a combined energy-materials weighting of about 17 per cent. The MSCI Europe Australasia Far East (EAFE) index, a benchmark for funds that invest everywhere but North America, has a commodity weighting of about 18 per cent. Watch the financials, though. The sector dominates both indexes with weightings of about 20 per cent.

It's the U.S. market that looks most inviting right now, though. It's a much stronger performer of late than either Canada or the EAFE index. Over the past 10 years, though, it's the laggard. In Canadian dollars, the S&P 500 had an annual average loss of 0.02 per cent over the decade to April 30, while the EAFE index made 1.1 per cent and the S&P/TSX composite made 7.4 per cent.

Exchange-traded funds that track major stock indexes are an ideal instrument for diversification of a portfolio into the U.S. market. Between the TSX and the New York Stock Exchange, there are ETFs covering all the indexes mentioned here.

U.S., global and international equity mutual funds are other options. (International funds invest outside North America, global funds can go anywhere.) But recognize that many funds can't keep up with their benchmark indexes. Suggestion: Seek out mutual funds that have managed competitive, if not necessarily index-beating, returns with lower risk than their peers.

I ran a screen on our Globeinvestor Gold website for funds like this and came up with one standout name, Mackenzie Ivy Foreign Equity. It has close to half the volatility of the MSCI World index and fell not even 7 per cent in 2008 while global funds fell 34 per cent on average. The fees are high at 2.47 per cent, but returns have beaten the world index over many periods. Commodity content is negligible, while consumer stocks dominate. Now, that's a hedge for a portfolio with a lot of Canadian content.

By Rob Carrick | From Globe and Mail, May 2012