

Go global: Why invest abroad



QUICK FACTS:

- In 2014, the world generated over \$77 trillion in GDP, to which Canada contributed only 2.3%
- The average Canadian has 95% of their assets tied to Canada
- Riskiness of foreign investments is a thought embedded in old perceptions

BENEFITS OF ADDING GLOBAL EXPOSURE:

- Gain exposure to successful innovative industries under-represented in Canada
- Allows investors to capture potentially faster growth from other economies
- Global exposure creates opportunities to gain attractive returns and reduce volatility

In 2014, the world generated over \$77 trillion in GDP.¹ Canada contributed a modest 2.3%, roughly in line with its historical average on the global scale. Despite this, the average Canadian's portfolio shows a lack of global exposure. Years of surging commodity prices have conditioned investors to expect Canadian investment performance to match or surpass their global counterparts. However, we need only look at how Canadian equities have underperformed U.S. equities for the past five calendar years to understand this will not always be the case. Investors need to take a serious look at their asset mix to ensure they're effectively positioned to benefit from growth opportunities around the globe, instead of relying solely on the strength of Canada's economy and commodity markets to reach their investment goals.

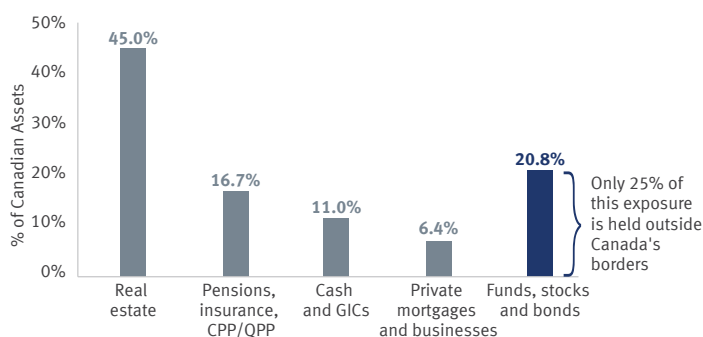
Canadians are heavily invested in Canada

By virtue of living, working, and owning a home, Canadians are exposed to fluctuations in the domestic economy and business cycle. Employment, wage growth, home prices and consumer spending all rely on continued strength in the economy. As a result, it's important that financial assets provide diversification and exposure to other economies to help mitigate the effects of any downturns in Canada.

¹World Bank; December 29, 2015; <http://data.worldbank.org/data-catalog/GDP-ranking-table>.

Canadians maintain a majority of their assets within Canada's borders. As of 2014, approximately 80% of Canadians' assets were purely domestic, including real estate, GICs, public pension plans, and equity in private businesses.² Of the remaining 20% of assets invested in financial vehicles including fixed income, equities and market-linked notes, only 25% were allocated to U.S. and foreign investments.² This means that **the average Canadian has 95% of their assets tied to Canada**, resulting in significant country-specific risk.

The average Canadian has 95% of their assets tied to Canada



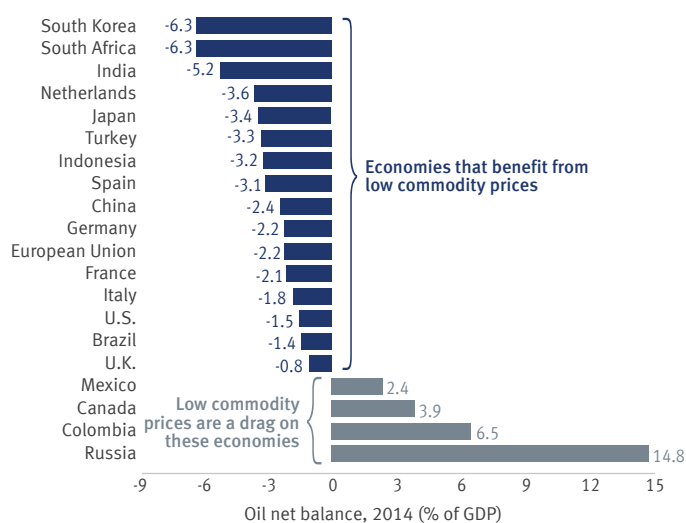
Source: Investor Economics; 2015 Household Balance Sheet Report. Data as of December 2014.

Global economies are driven by different forces

Canada's economy is cyclical and tied to commodities, meaning performance is strongly influenced by the strength of the commodity market. Falling commodity prices and a weakening Canadian dollar drove a broad sell-off in Canadian equities, sending the market down over 10% between July 1, 2014 and December 31, 2015.³ While commodity markets appear to have stabilized, earnings growth is heavily dependent on a recovery in the price of oil. Many other countries have considerably less of their market directly exposed to the energy and materials sectors, allowing them to fare better than Canada's market when resources perform poorly. While it's important for investors to have some cyclical exposure, it's equally important to diversify into global markets that provide access to sectors that experience growth during cyclical downturns.

Uneven economic growth and inflation across countries and regions also present opportunities for global investors. Many global economies currently benefit from low commodity prices, rebounding housing markets, and strengthening consumer balance sheets. These act as tailwinds to growth as they spur activity and consumer spending. By contrast, many of these factors are headwinds to growth in Canada, as falling commodity prices have hurt the economy, consumer debt levels are high, and parts of the housing market are potentially overheated. It's possible these headwinds may persist for a considerable period of time, constricting growth potential and ultimately weighing on return potential. Thus, adding global exposure to a Canadian-centric portfolio allows investors to capture potentially faster growth from other economies.

Many countries are net importers of oil and benefit from lower commodity prices



Source: BP Statistical Review of World Energy 2015, Haver Analytics, RBC GAM.

Harness innovation and R&D

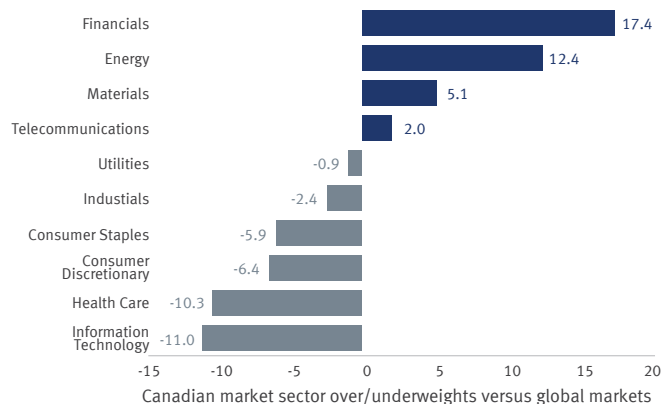
Investing globally improves sector diversification as a portfolio gains exposure to industries under-represented in Canada. These include consumer staples, health care, consumer discretionary and information technology, some of which are important sources of returns and others which offer defensive characteristics during cyclical downturns.

² Investor Economics; 2015 Household Balance Sheet Report; www.investoreconomics.com.

³ Morningstar Direct. Based on performance of the S&P/TSX Composite TR Index from July 1, 2014–December 31, 2015.

For example, the MSCI World Index, which represents the global equity market, contains 127 health care companies, compared to only three in the S&P/TSX Composite. It includes names like Bayer, which owns brands like Aspirin, Claritin, Coppertone and Dr. Scholl's. Roche, a global innovator in developing treatments for cancer, debilitating and infectious diseases and neurological disorders, is also a component. These are companies creating global products and performing ground-breaking research, and a Canadian-centric investor would not have exposure to these areas of growth. Globally, consumer staples giants such as Nestlé, the world's leading nutrition, health and wellness company, is also publicly-traded and has no equivalent in the Canadian marketplace.

Global markets have increased sector diversification



Source: RBC GAM, MSCI. Canadian market: S&P/TSX Composite; global markets: MSCI World. Data as of December 31, 2015.

Having assets exposed to areas of innovation may be an important driver of future returns. Research and development (R&D) continues to surge, with data showing 70% growth in R&D spending over the last 10 years.⁴ Computing and electronics, health care and auto companies continue to spend the most on R&D, and Canadian companies are notably absent from the lists of top 10 innovators (refer to above table). In fact, the areas experiencing the most innovation include health care, technology, industrials and consumer discretionary, which make up less than 20% of Canada's stock market. Studies have indicated that companies which spend considerably less than the median company on R&D leads to consistently lower

Canadian companies are not represented amongst the world's most innovative

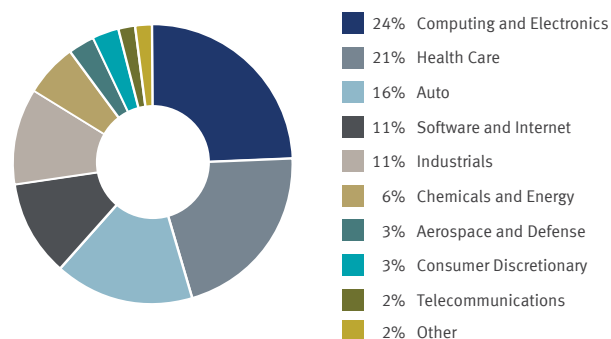
Rank	2010	2011	2012	2013	2014	2015
1	Apple	Apple	Apple	Apple	Apple	Apple
2	Google	Google	Google	Google	Google	Google
3	3M	3M	3M	Samsung	Amazon	Tesla
4	General Electric	General Electric	Samsung	Amazon	Samsung	Samsung
5	Toyota	Microsoft	General Electric	3M	Tesla	Amazon
6	Microsoft	IBM	Microsoft	General Electric	3M	3M
7	Procter & Gamble	Samsung	Toyota	Microsoft	General Electric	General Electric
8	IBM	Procter & Gamble	Procter & Gamble	IBM	Microsoft	Microsoft
9	Samsung	Toyota	IBM	Tesla	IBM	IBM
10	Intel	Facebook	Amazon	Facebook	Procter & Gamble	Toyota

Source: Strategy & 2015 Global Innovation 1000 survey data and analysis.

performance, making it important that investors consider how much growth potential is in their portfolio.⁵ Notably, in 2013, Canada's R&D spending to GDP ratio was nearly 30% below the OECD (Organization for Economic Co-operation and Development) country average while Asia is now the number one region for corporate R&D spending.⁶

2015 R&D spending by industry

More than 80% of spending occurred in industries that make up less than 20% of Canada's market



Source: Strategy & 2015 Global Innovation 1000 analysis, Bloomberg data, Capital IQ data.

^{4,5} <http://www.strategyand.pwc.com/media/file/2015-Global-Innovation-1000-Fact-Pack.pdf>

⁶ http://www.statcan.gc.ca/access_acces/alternative_alternatif.action?teng=88-221-x2015001-eng.pdf&tfra=88-221-x2015001-fra.pdf&l=eng&loc=88-221-x2015001-eng.pdf

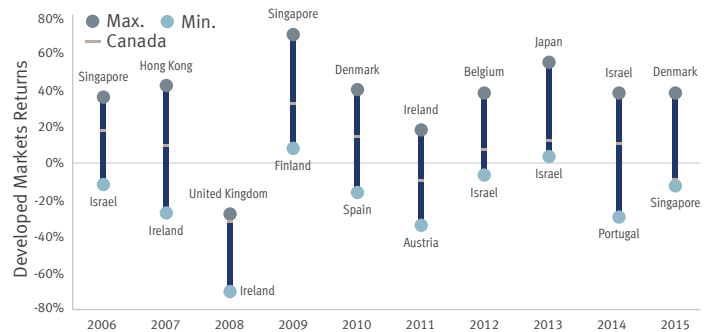
Return differentials wider than many expect

Annual returns vary across markets depending on growth opportunities, valuations, and the underlying structure of the market. Given how tied markets are to one another, many would expect returns to be relatively similar. However, an analysis of individual country returns, measured in local currencies to remove the effect of fluctuating exchange rates, shows that the dispersion of returns across developed nations averaged 52% between 2000 and 2015. Thought of another way, an individual who invested all of their assets in a single country could experience a very different outcome depending on the country chosen. While Canada's equity market performed reasonably well during the resource boom, it has underperformed by a wide margin in recent years as commodity prices declined. A global investor would have benefitted from being invested in a variety of these markets.

Across emerging market nations, the dispersion of returns is further magnified. Since 2006, the yearly dispersion of returns across geographies has measured 106% – a difference that implies one individual's experience could be double the return of another person over a one-year period. Attractive returns may be found all over the globe for those who know where to look and have the skillset to choose investments wisely. Investing in just one country magnifies the country-specific risk an investor faces, while investing in a well-diversified global portfolio run by a skilled manager provides access to a variety of countries and allows the manager to determine where the best opportunities exist on an ongoing basis.

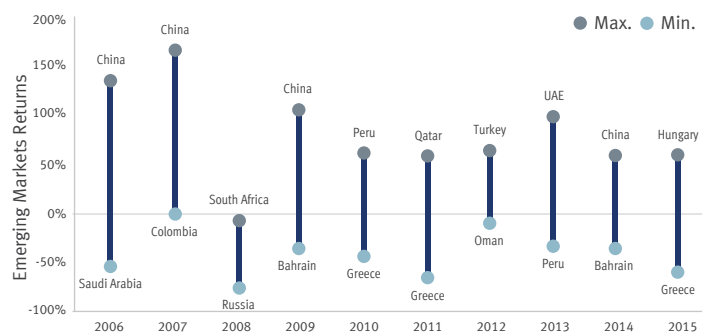
Similar dispersion can also be observed across bond markets, which would imply there are opportunities to add value and excess returns by choosing and frequently rebalancing asset allocation in the space.

Wide dispersion of returns across developed markets ...



Source: Morningstar Direct. Data based on calendar year returns of MSCI developed country indices from 2006–2015.

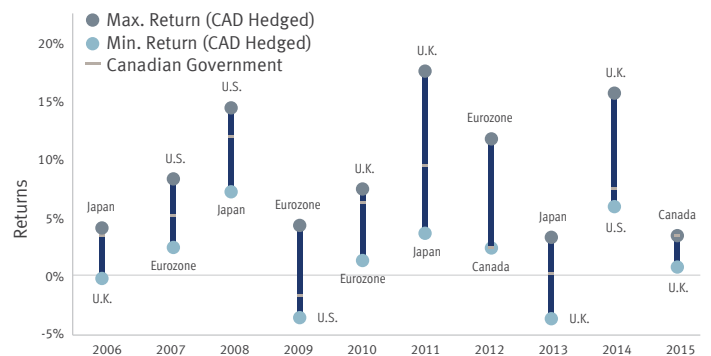
... and even wider across emerging markets



Source: Morningstar Direct. Data based on calendar year returns of MSCI emerging market country indices from 2006–2015. China refers to 'A' share market.

Global bonds offer more diversified return potential

The wide dispersion of returns from global government bonds can offer greater opportunities



Source: Citigroup, RBC GAM. Data as of December 31, 2015.

Adding foreign investments doesn't always equal more risk

RRSP accounts were introduced in 1957 and came with limitations on foreign holdings, which were ultimately eliminated in 2005. Prior to being abolished, skirting around these restrictions involved the use of derivatives, swaps and clone funds. These vehicles came with high management fees and were only available on a small subset of foreign investments, making foreign content inherently more risky and leading to the perception that global exposure equals additional risk.

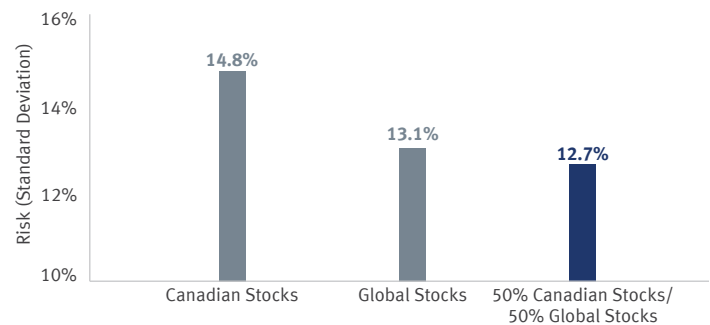
Today, it's easier than ever for Canadians to access global markets. Mutual funds have increased in sophistication and vehicles like ETFs and structured notes have proliferated. The absolute number of international and global funds in Canada has increased by nearly 35% over the last 10 years, while the assets following these vehicles have more than doubled – though they still represent less than 25% of total assets in the industry.⁷ Many global balanced products now include allocations to emerging markets as an important source of return potential that brings attractive diversification benefits when used judiciously. Gone are the days where investors need to use risky vehicles with high fees to appropriately diversify their portfolio – and yet, data demonstrates that the average Canadian still maintains nearly 95% of their assets domestically.

Global exposure can reduce volatility

A number of factors can influence volatility in the market. These include the cyclical make-up of the underlying economy, the sector breakdown of the market and volatility in earnings of underlying companies, as well as how tied the market is to other nations. Canada, as a cyclical country that's heavily reliant on resources, tends to experience higher levels of volatility on a year-to-year basis, particularly relative to countries like the U.S., which are larger and more insular. This volatility can be reduced by supplementing Canadian exposure with global exposure, as the two portions of the portfolio may respond differently to changing circumstances.

Global diversification can reduce risk

Volatility over 35 years ended December 31, 2015



Source: Morningstar Direct based on performance of S&P/TSX Capped Composite Index, MSCI World Net Index (CAD) annualized volatility as of December 31, 2015.

Conclusion

The opportunities for growth outside of Canada are vast. Investors stand to benefit from taking a global focus, thereby allowing them to experience potentially higher growth, lower volatility, and enhanced diversification. Moving even some of the Canadian exposure outside of Canada would go a long way towards reducing the country-specific risk that Canadians experience on a day to day basis, and allow portfolios to harness the research and innovation that's occurring outside our borders.

⁷ IFIC, RBC GAM.

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