

## Surging Resources Mask Weakness in Canadian Equities July 18, 2008 | Mark Noble

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The recent pullback in the S&P/TSX Composite Index, due to declining energy prices, highlights the narrowness of the Canadian market. So while Canada has been the one bright spot amongst the world's major markets, investors who use the index as their template for their Canadian equities exposure are invariably overexposing their portfolio to commodities risk.

According to a report released last Friday by CIBC World Market's economist Meny Grauman, the S&P/TSX Composite Index seems to have decoupled itself from the major U.S. markets.

Grauman highlights that, during the last five bear markets, the Canadian stock market has marched lock-step with the S&P 500. This is no longer the case.

"The first one to hit during this period was in 1973-74, in the wake of the Vietnam War, while the most recent one was a casualty of the tech bubble in 2000-02. During these various downturns, the S&P500 composite fell by an average of 11% a year, while on average, the TSX also declined by exactly the same amount," he says. "An examination of the correlation in quarter-to-quarter return patterns shows that while most developed country equity markets have become much more correlated in recent years, the degree of correlation between the TSX and the S&P 500 has actually declined since early 2000 and the end of the Internet stock bubble."

The reason is primarily commodities. While global credit worries hammer the world's financial system, demand for commodities from emerging markets remains strong. Investors turn to energy and materials to continue to ride out uncertainty in other markets. The Canadian stock market, flush with resource producers, has been the big winner from this movement.

As resources moved up, other sectors, like the index heavyweight financials, have moved down, creating a staggering imbalance to the weighting of the S&P/TSX Composite towards the energy and materials sector.

Sector data provided by S&P of the composite index shows that since October, when most of the world's major markets started their trek into bear market territory, the energy sector has gone from a market capitalization of \$418 billion to more than \$500 billion by the end of June. The materials sector has gone from \$280 billion to \$311 billion.

Corresponding to this have been significant drop-offs in other sectors, most noticeably financials, which have gone from approximately \$462 billion in market capitalization to \$380 billion. The weighting to resources has grown substantially.

"What I think is interesting, to look at the price return of the TSX for one year ended June 30, the return was about 4%. But the median return, which is kind of the halfway point for the index, was -10% over the same period," says Suzann Pennington, portfolio manager with Howson Tattersall Investment Counsel.

"Total return for the TSX for one year to June 30 was around 6.7% and three stocks, Potash, RIM and Encana, represent about 6.2% out of 6.7%. That just gives you a flavour for how narrow the performance has been."

It's partly due to this narrowness that Pennington, who employs a value discipline for the funds she manages on behalf of companies like Saxon and other asset managers like Altamira, doesn't use an index as a benchmark. She suggests retail investors also avoid using one as a benchmark to determine their Canadian equity weighting.

"The TSX is not constructed for retail investors to think of as a diversified portfolio. It historically has not been a good diversified portfolio. If you look back to when energy pricing bottomed, 8% of the index was in energy; that was the best time to be buying energy and yet the index would not have had you there," she says. "Materials and Energy are over 50% of the index. That's not a properly diversified portfolio for an individual to have. Investors need to be aware of the kind of risks they are taking on if they use that as a guide for the portfolio."

Clancy Ethans, chief investment for Richardson Partners Financial, remains bullish on energy prices over the longer term, but he thinks a 32% indirect exposure to energy, which is what they would have if their Canadian equity holdings hug the index, is too risky a position to have.

"In financial services, you can buy some Manulife or some asset management companies and you diversify to a degree. In energy, whether you buy Encana, or you buy driller, if the price of oil gets clobbered, it doesn't matter which stock you're in, you're going to get clobbered," he says. "A similar situation happened a few years back with Nortel. One stock became a massive piece of the overall S&P/TSX. That's when some managers started using a capped model of the S&P/TSX as their benchmark."

Ethans also notes if investors want any of their core U.S. or non-resource Canadian holdings to go up, there is going to have to be a pull-back in energy.

"You're facing a dichotomous economy here in Canada. Problem is if the U.S market and the Canadian market need some kind of event for things to go higher. One of them clearly needs to be a lower oil price. That would be bad for the western provincial economies and good for the eastern ones," he says.

Still, there is a silver lining to the dichotomy, and that is value opportunities in other Canadian sectors, particularly non-resource sectors that have been ignored amongst the noise of the commodities frenzy, says James Cole, senior vice-president and portfolio manager for AIC.

Cole says he's finding great opportunities to add value to some of the funds he manages such as the AIC Canadian Focused Fund as well as the Canadian Balanced Fund.

"We like the businesses that are evergreen perpetual businesses; those tend to be the financials and consumer-oriented businesses. The share prices, though, have not been particularly high, even for companies that haven't had any adverse problems in their businesses," he says.

There are further inefficiencies in some of the beaten-up sectors, since international investors in particular have largely ignored the non-resource market, he notes.

"Many international investors say we've got our own banks, we've got our own consumer companies. They come to Canada for the energy and materials companies that we have. There are opportunities in some Canadian businesses that are comparatively overlooked," Cole says.

Pennington adds, on sector-by-sector comparison, the Canadian market has performed much better than the same sectors in other markets. The most glaring is in Canadian Financials. The financials on S&P 500 are down over 30%. In Canada they have been beaten but are only down 13%.

In addition, the materials and energy sectors have outperformed the U.S., which Pennington attributes to the fact they are more tightly involved in the actual production in resources, rather than cursory production like domestic gasoline refineries, which have been hit hard by soaring crude prices and decrease in gasoline demand.

"Our stocks have significantly outperformed, because the fundamentals have significantly outperformed," she says. "We are finding values in a variety of sectors, resource and non-resource. For instance, the energy sector year-to-date is up 8% but the stocks still haven't moved to reflect the massive increase in the oil sector. We have a 22% weighting in energy that includes pipeline stocks. But we are not at 35% - because that would be inappropriate from a diversification perspective."