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CIBC CAPITAL MARKETS

EQUITY RESEARCH

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September 4, 2023 **Industry Update**

Diversification or "De-Worsification"?

Home Country Bias Has Left The Building

Sector:
Portfolio Strategy

Our Conclusion

For the past 15 years, two of the traditional supporters of Canadian public equities have been reducing exposure to Canada. Mutual fund buyers have shifted their equity holdings meaningfully from Canada to U.S. and International markets. And, Canadian pension plans have substantially increased proportionate exposure to private assets.

While we do not see either trend reversing, we see some indications the majority of the shift has already occurred. Canadian-oriented mutual funds are no longer losing share to foreign mutual funds. As well, given the slower repricing of private assets relative to public assets, Canadian pension plans already have close to half their assets in Alternatives. Though we remain cautious on equities overall, we believe an end to the shift out of Canada should provide some support for the S&P/TSX.

Key Points

Domestic mutual funds and pension plans have traditionally been big buyers of Canadian equities. Despite strong long-term relative performance for Canadian equities and "home country bias", there seems to have been a significant aversion to domestic stocks over the past decade and a half.

While we would expect investors to search out the benefits of diversification by buying Technology and Health Care stocks in the U.S., the reality is that many investors have also shifted into international stocks. This is fine in principle, but the long-term reality is that Canadian equities have trounced stocks in most developed markets.

Domestic pension plans have also seen declining exposure to Canadian stocks. Not only have they reduced Canada within their equity holdings, they have also made a meaningful shift into private assets. At the end of 2022, Canadian pension plans seem to be twice as committed to private assets as are pension plans in other developed markets.

It is difficult to know the end point of either trend. However, we see some signs the worst is behind us. Canadians no longer seem to be shifting asset mix to non-Canadian mutual funds. In the case of pension plans, the slow repricing of private assets relative to publicly traded assets probably pushed the reported asset mix strongly away from public equities in 2022. We believe most of the shift to private assets has occurred in Canada.

This is not a rousing endorsement of Canadian equities. However, in an environment of slowing economic activity and elevated interest rates, and against the backdrop of low valuations for domestic stocks (relative to the U.S. and to long-term averages), we believe the S&P/TSX can produce good relative returns.

All figures in Canadian dollars unless otherwise stated.

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Domestic Institutional Interest Is Important

Tracking ownership of public companies is a never-ending process of “chasing one’s tail” – you are always almost there, but never quite. While some owners of securities do disclose their holdings, many do not and even those who do often delay reporting for an extended period.

Having said this, we believe for most Canadian equities, direct ownership of stocks by independent individuals represents 35%-45% of total capitalization, a further 3%-5% is owned by insiders, and the remainder is held by institutional investors. Within the institutional segment, the largest holders of a public Canadian company are likely to be mutual funds, followed by hedge funds, pension plans, insurance companies and investment dealers.

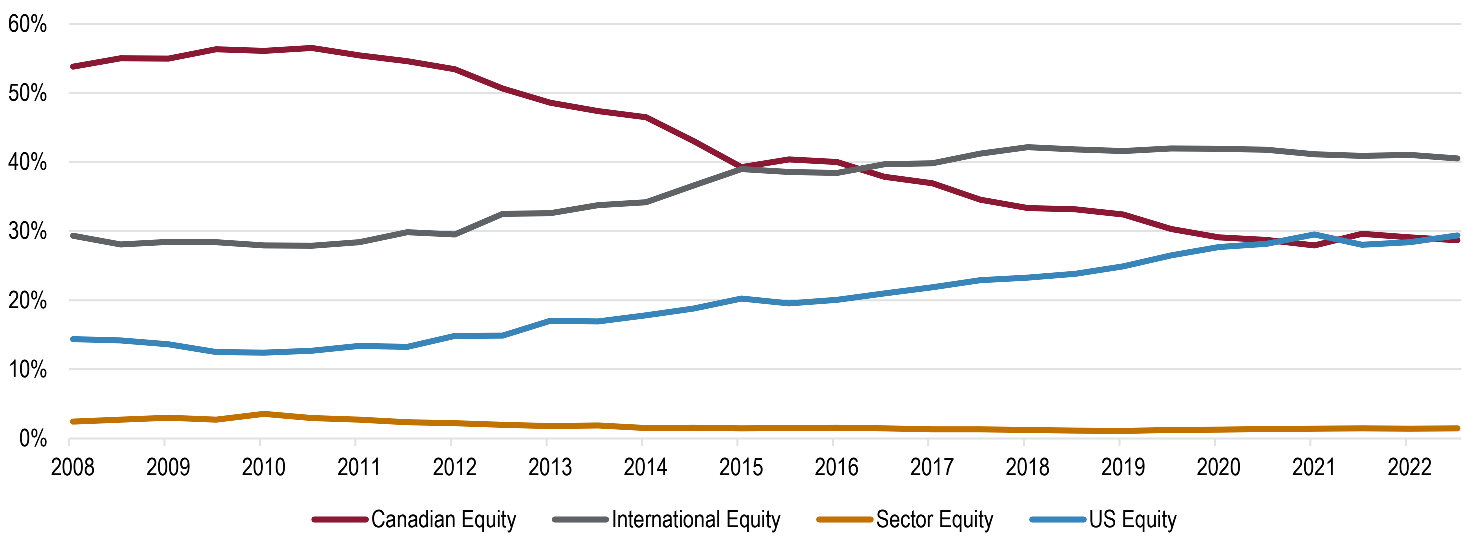
In our opinion, the most “natural” institutional owners of Canadian equities would be domestically created mutual funds and domestic pension plans. To state the obvious, mutual funds are unitized products purchased by individuals, and while the mutual fund manager has some discretion, the type of fund purchased largely determines the regional make-up of the securities held in any mutual fund. A Canadian equity fund will largely own Canadian equities (about 85%, as we detailed in a recent report). An international or U.S. mutual fund bought by a Canadian investor would not be expected to own many (if any) Canadian stocks.

The other large traditional buyers of Canadian equities are domestic pension plans, private and public sector (with the latter dominated by the “Maple Eight” – CPP, PSP and six provincially oriented plans). Unfortunately, data suggests both domestic mutual funds and pension plans have been shifting away from Canadian public equities for the past decade.

Canadians Seem Intent On Buying Mutual Funds That Aren’t Canadian

Over the past 15 years, Canadian individual investors have increasingly shunned domestically oriented mutual funds in favor of funds that are heavily focused on American and International securities. Canadians have shifted their investment dollars from 55% Canadian equity mutual funds to 29% over the past decade and a half (see line chart, Exhibit 1). U.S. and international-oriented mutual funds (manufactured by domestic issuers) have seen their combined share rise to about 70%. International funds saw most of their proportionate growth in the 2012–2018 period.

Exhibit 1: Canadian Mutual Funds – Percent Of Equity Fund AUM By Geographic Region – Jun 2008 To Dec 2022



Source: Lipper and CIBC World Markets Inc. Sector Equities include narrowly focused mutual funds such as those targeting technology or financials.

Diversification is certainly a creditworthy initiative, but there are occasions when the benefits are outweighed by poor relative performance. The U.S. has been a clear winner in terms of performance over the long term but Canada has generally been one of the better relative performers. On the other hand, heavyweight country markets such as Japan, the UK and Germany have generally generated disappointing returns (see table in Exhibit 2).

Exhibit 2: Global Indices – Total Return Performance – Select Time Periods

Country	Index	30-yr Avg	Last 5 Yrs	Last 10 Yrs	Last 20 Yrs	Last 30 Yrs
USA	S&P 500	11.5%	11.1%	12.8%	9.9%	10.0%
Canada	S&P/TSX Comp.	10.8%	6.9%	5.4%	8.2%	8.0%
World ex US	MSCI ex US	9.9%	5.4%	5.7%	7.0%	5.6%
UK	FTSE 100	7.0%	3.2%	3.4%	5.7%	5.2%
France	CAC 40	6.6%	7.7%	7.7%	7.5%	4.4%
Germany	DAX	7.0%	3.6%	5.0%	7.9%	3.9%
Japan	Nikkei 225	5.2%	3.5%	7.0%	6.5%	1.7%
	Average	**8.3%**	**5.9%**	**6.7%**	**7.5%**	**5.5%**

Source: Bloomberg and CIBC World Markets Inc. 30-yr Avg is the average of annual returns over the past three decades.

As such, buying a broad range of U.S. stocks has been beneficial to performance but the decision by many Canadians to shift investment dollars from Canada to Europe or Japan or to most other (non-U.S.) markets has been negative. If we consider Sharpe Ratios, the conclusions stands: a portfolio that is 30% Canada and 70% U.S. has materially better Sharpe Ratios than one which is 30% Canada and 70% MSCI World. Note the MSCI World is still ~69% U.S as of July 2023.

If there is any good news in the data, it is that Canadians seem to have reached their limit on non-Canadian mutual funds. As the line chart in Exhibit 1 indicates, the market share for Canadian mutual funds has consistently been 30% over the past two years.

Canadian Pension Plans Seem To Have Given Up On Public Equities

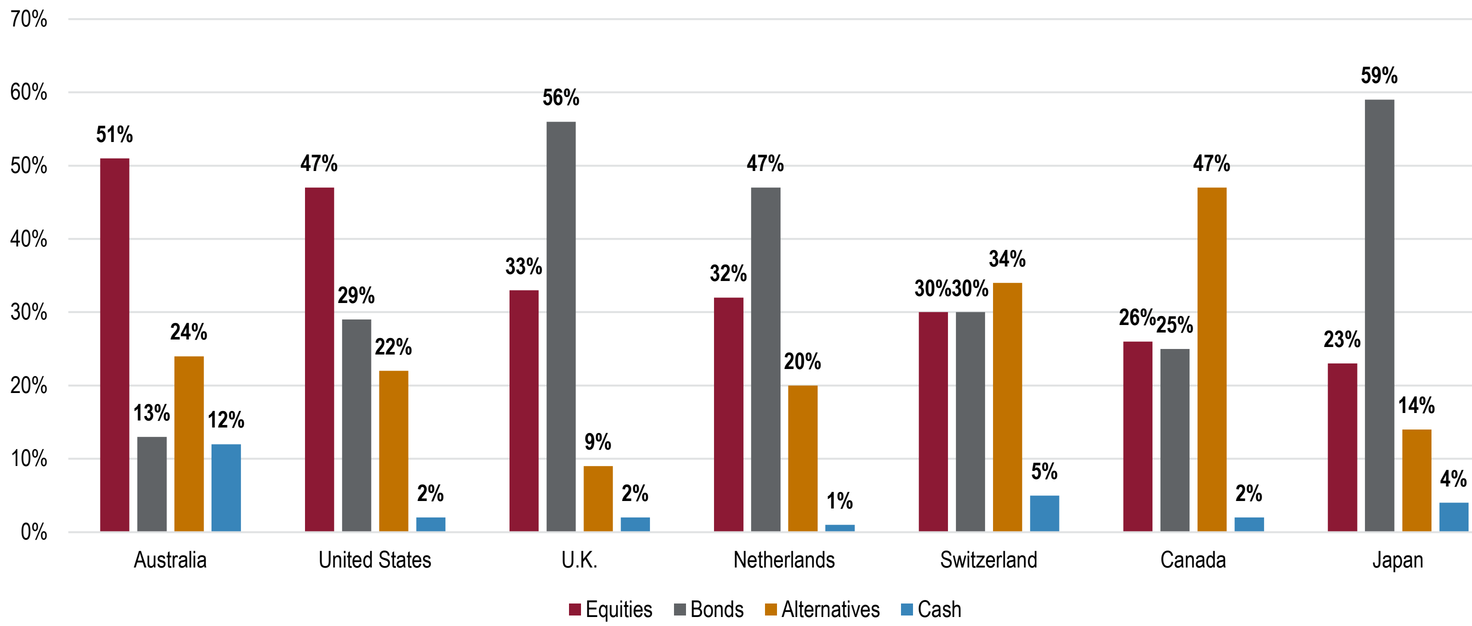
Traditionally, pension managers invest in assets that largely match the retirement liabilities they back, while also searching out the best risk-adjusted returns. Ceteris paribus, overwhelmingly backing Canadian pension liabilities (which would similarly be affected by Canadian economic conditions) with Canadian equity and fixed income assets would be intuitive. The issue is obviously more complex than that.

There is a strong case to diversify given the relatively concentrated nature of domestic Canadian capital markets. Investors have very few options to gain exposure to Health Care and Technology, areas that are extremely important in the Canadian economy. In the U.S., there is a raft of alternatives in these sectors so a pension manager will rightly seek these out. As such, large ownership of non-Canadian equities is to be expected.

Furthermore, pension managers face a reality that volatility in market conditions can produce significant risks. A sharp decline in interest rates, such as was experienced during the COVID period, caused liabilities to spike (due to lower discount rates). At the same time, equity pricing suffered. While this situation corrected itself relatively quickly, some pension plans could easily have had solvency concerns.

The second concern seems to be most tangible for Canadian pension plan managers. In aggregate, Canadian pension managers typically have twice the allocation to alternative assets than do pension plans in other parts of the world (bar charts, Exhibit 3). In our opinion, this partially reflects scale – Canada's pension landscape is dominated by a handful of plans. To invest efficiently in Alternatives such as private equity, private credit, real estate, and/or infrastructure, a plan likely needs a minimum asset base to support internal management. Clearly the Maple Eight, which are large even by global standards, more than meet such minimums.

Exhibit 3: Global Pension Plan Holdings – By Asset Allocation – December 2022



Source: Thinking Ahead Institute (Willis Towers Watson) and CIBC World Markets Inc. Alternatives include real estate, infrastructure, private equity and private credit.

There is clearly justification for pension plans to include some exposure to Alternatives in their asset mix – and the cynic would point to the gradual “moving to market” valuation approach as the biggest “benefit” given the potential volatility of public assets. However, the reality is Canadian pension plans have done this largely at the expense of public equities. In fact over the past five years, public equities have declined from over 40% of total assets to the 26% level at the end of 2022 (the red bars in Exhibit 3).

Not only have Canadian pension managers reduced proportionate public equities holdings, they have (like their mutual fund peers) also reduced proportionate exposure to domestic equities, in favor of non-Canadian equities. One of the higher-profile Canadian investment managers, Letko Brosseau, has publicly called for changes to restrict (and possibly reverse) some of these trends.

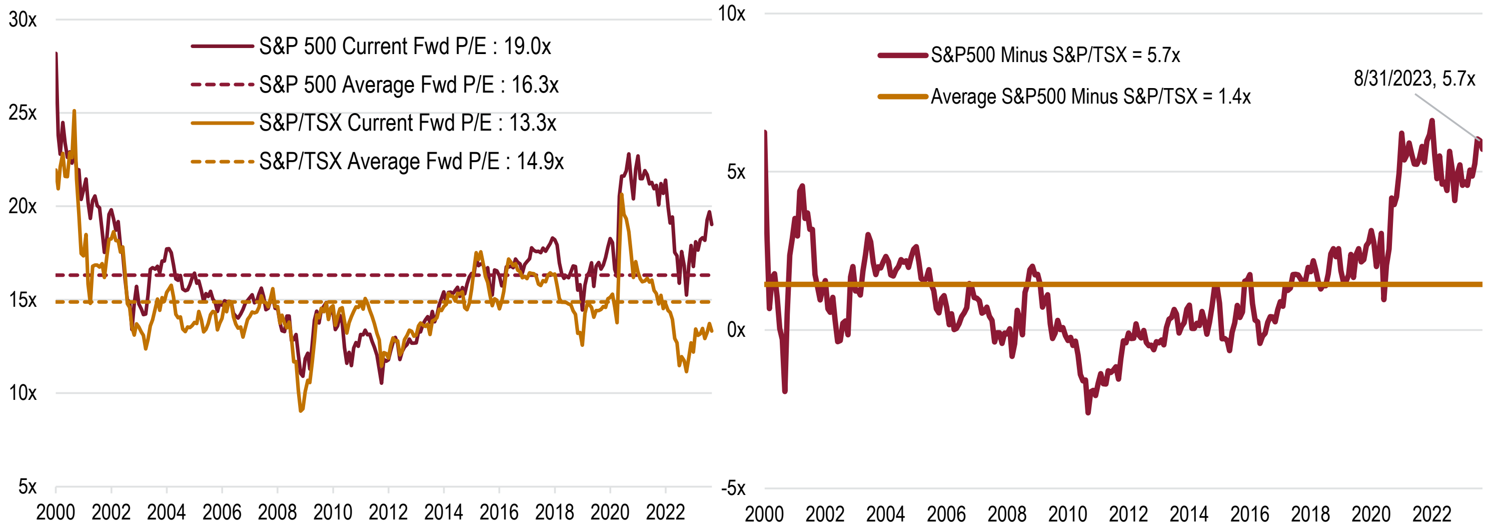
As is often the case, the “invisible hand of the market” may already be dealing with this. The slow re-pricing of Alternatives likely boosted their share within asset mix at the end of 2022 – remember equity and bond prices corrected rapidly in 2022 while private marks were clearly slower-moving. This probably resulted in a more rapid change than planned in reported asset mix shift, in favor of private assets. With the rebound in equities, the situation in mid-2023 would likely be reversed modestly, but our sense is the majority of the conscious asset mix shift away from public equities within big Canadian pension plans has already occurred.

Not Surprisingly, Canadian Equity Valuations Have Suffered

Less support from two of the larger domestic institutional buyer groups has inevitably had a negative impact on Canadian equity valuation. Remember that these two would be expected to own 20%–30% of all Canadian equities. While they remain important holders, the continued downshifting within their asset mix means they have been smaller net buyers than one might expect.

Canadian equities are now at some of the largest discounts to U.S. equities in the past quarter century (line charts, Exhibit 4). Specifically, Canadian equities are nearly six multiple turns lower than the S&P 500 valuation (RH panel). This compares to the long-term average spread of 1.4x.

Exhibit 4: Forward P/Es – S&P/TSX And S&P 500 P/Es And P/E Spread – 2000 To Current



Source: FactSet and CIBC World Markets Inc.

There are certainly other variables that have caused the large discount to occur. Importantly, and as we have discussed in the past, the valuation of the S&P 500 has been boosted by a narrow group of growth stocks. There is a case to be made that the high valuation of the U.S. market is partially a reflection of its sector representation – with a high proportion of stocks in sectors with traditionally higher valuations.

Having said this, the S&P/TSX is not only cheap relative to the S&P 500, it is also cheap relative to its longer-term history. The S&P/TSX is currently trading at 13.3x forward EPS estimates, versus a long-term average of 14.9x (LH panel, Exhibit 4). Some of this is likely due to the lack of incremental flow into Canadian-oriented mutual funds and from a continued shift to private assets by domestic pension managers.

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