Breaking Concentration

Equity Markets

The first quarter of 2017 saw a continued risk appetite across major equity markets. In Canadian dollar terms, Canada (S&P/TSX Composite) returned 2.41%, surpassed by the U.S. (S&P 500) at 5.23% and International markets (MSCI EAFE) at 6.40%. Contrary to widespread predictions that emerging markets wouldn't perform well in light of President Trump's protectionist policies, emerging markets staged a nice rally in the first quarter, up 10.57%.

This was a quarter with ample noteworthy events. The U.S. Federal Reserve raised its benchmark interest rate to a range between 0.75% and 1.00%, its second rate hike in three months but only the third increase since the global financial crisis in 2008. Interpreting the accompanying commentary as not overly hawkish in tone, equity markets reacted to the rate hike more like it was a rate cut, rising further on the day. The UK triggered Article 50 near quarter end and started the process of officially exiting the European Union. The G20 omitted its pledge to fully resist U.S. protectionism. The Dow Jones Industrials index passed the 20,000 mark for the first time ever, and proceeded to push onwards through 21,000 before retracing. Finally, during the Dutch election in March, the Dutch electorate defeated populism by denying the bid by the Party for Freedom (PVV), perhaps a sign that the power of populism, in this case, to break up the Eurozone, is less than feared. Next up, the upcoming French presidential election in the second quarter.

Fixed Income

Core fixed income returns were modest in the quarter, with Canadian bonds (FTSE TMX Canada Universe Bond index) returning 1.24%. Yields gyrated, with the ten year Canadian government bond starting the quarter at a 1.74% yield, reaching a high of 1.87% and ending at 1.63%. Canadian short term bonds fared worse, returning over 0.67% over the quarter, while high yield bonds did the best within the Canadian fixed income market, returning 2.50% in sympathy with stronger stock markets.

The Bank of Canada's January Monetary Policy Report reported that the rapid back-up in global bond yields, partly reflecting market anticipation of U.S. fiscal expansion, has pulled up Canadian yields relative to their prior October expectations. The Bank projects that Canada's real GDP will grow by 2.1% in both 2017 and 2018, implying a return to full capacity around mid-2018. This slightly improved outlook helped keep the Canadian dollar roughly flat, at US$0.75, despite the price of West Texas crude oil dropping from around $55 to $51 over the period.

Commentary

In 2016, Canada produced some of the best investment returns among developed equity markets, a welcome relief after five years of middling performance. As long-term investors it is a good time to pause and evaluate our portfolio asset allocation, or to put it more simply, address "how much we have where". We want to avoid too much of anything: too much in one country, too much in one sector, or too much in one company. Looking specifically at the Canadian stock market there are some issues that are the same as always, but some things that don't feel quite as good as before. This last point deserves some elaboration.

One longstanding issue that remains the same is sector concentration – 70% of the Canadian market is in Financials, Energy and Materials. Banks, a big part of the Financials sector along with insurance companies and asset managers, in particular have done well over the last decade, a span that even includes the 2008 Financial Crisis. As for the Energy and Materials sectors, however, longer term performance has been much more anemic. Given the heft of these two sectors in the domestic market, this creates a problem for Canadian investors facing a relatively smaller pool of stocks to consider outside of these industries. More seasoned investors may recall some speculation during the 1980's that these basic resource sectors could become key contributors to a "new" global economy, a view that has largely failed to materialize.

In comparison, the U.S. market presents a much more diverse and globally representative breakdown. Here, the best performing sectors in the S&P 500 index over the last decade have been Consumer Discretionary, Health Care and Information Technology. Within each, a number of high quality businesses with global leadership positions have led the way, including household names like NIKE, Johnson & Johnson, Microsoft and even UnitedHealth. Notably, these three sectors account for 45% of the U.S. market, dramatically higher than the 8% they represent in our domestic TSX Composite index. The chart below ranks the sector performance in the U.S. for each of the past ten years, with the top row being the best performer. The sectors that frequently appear in the top three performers are Consumer

Discretionary, Health Care and, interestingly, Utilities. Once again, the sum total of these three sectors in our domestic market is a much less substantial 8%. This issue isn't a new one facing Canadian investors, but leaves us feeling more wary about dedicating incremental capital into pulling hydrocarbons out of the ground versus alternatives that might include investing in a new surgical device, software application or retail brand.

Diversifying Sectors

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Telecomm	Energy	Cons Staples	Info Tech	Cons Disc	Utilities	Financials	Cons Disc	Utilities	Cons Disc	Energy
Energy	Materials	Health Care	Materials	Industrials	Cons Staples	Cons Disc	Health Care	Health Care	Health Care	Financials
Cons Disc	Utilities	Utilities	Cons Disc	Materials	Health Care	Health Care	Industrials	Info Tech	Info Tech	Telecomm
Utilities	Info Tech	Telecomm	Industrials	Energy	Cons Disc	Info Tech	Financials	Financials	Cons Staples	Industrials
Financials	Cons Staples	Cons Disc	Health Care	Telecomm	Energy	Telecomm	Info Tech	Cons Staples	Telecomm	Materials
Materials	Industrials	Energy	Financials	Financials	Info Tech	Industrials	Materials	Cons Disc	Financials	Utilities
Cons Staples	Telecomm	Industrials	Energy	Cons Staples	Telecomm	Materials	Cons Staples	Industrials	Industrials	Info Tech
Industrials	Health Care	Info Tech	Cons Staples	Info Tech	Industrials	Cons Staples	Energy	Materials	Utilities	Cons Disc
Info Tech	Cons Disc	Materials	Utilities	Utilities	Materials	Energy	Utilities	Telecomm	Materials	Cons Staples
Health Care	Financials	Financials	Telecomm	Health Care	Financials	Utilities	Telecomm	Energy	Energy	Health Care

Source: FactSet

Some will note that there have been other very good reasons for Canadians to be invested in Canadian equities historically, including some tax advantages on dividends and other nuances. However, these have been slowly eroded over the past decade, with the very real possibility that further steps might be taken towards eliminating these entirely. Savvy investors realize that tax is part of their investment equation but is seldom the best reason to make an investment decision.

Canadian institutions and pension funds are now well down the path of investing internationally to reap these diversification benefits. However, individual Canadian investors as a group still retain a high commitment of their investment dollars to domestic markets. They are not alone in this regard, with investors in nations like Australia behaving similarly, despite the same degree of local market concentration. One factor driving this overindulgence is simple familiarity with domestic companies and a high degree of local media coverage. Another is a relatively low level of commitment among investment industry firms to develop global investing expertise internally, shortchanging their clients as a result. This has been a key focus at Guardian in recent years, with the result being the establishment of our London UK-based Global and Emerging Markets equity groups to complement our domestic investment expertise.

The globalization of business trade arrived years ago and will continue to grow regardless of political and national protectionism policies. The genie is out of the bottle and progressive portfolios have moved on and recognize this. Diversification means having less of your portfolio in Canada, less of your portfolio in three sectors and benefiting from a broader array of opportunities abroad. Guardian clients have exposure outside of Canada and this commentary may seem counter intuitive given the recent strong year domestically. As long term prudent investors we continually work to better complement our domestic strategies, providing portfolios with sector diversification and opening up the opportunity to invest in best of breed companies wherever they may be in the world.