AGAINST THE FLOW

The Vestcap Point Of View

October 2015

Canada has always been considered a "commodity" stock market. Historically, what has been good for commodities has generally been good for Canadian stocks; when commodities run, our market rises to the top of the list of best performing markets around the world. Unfortunately, when commodities do poorly, so goes our market, as has been the case since 2014.

In volatile times like those just experienced, it seems particularly difficult to take a 10 year perspective when making an investment decision. Yet we know, through decades of investment experience, that all it takes for significant outperformance is one or two properly made long term decisions bought at a time when prices are low and the consensus view is negative.

Often times, the best place to start when looking 10 years out is to go back a decade and understand what happened. Looking "inside" the S&P/TSX marketplace is a great point of departure. The table to the right compares the primary constituent sectors of the market in September 2005 to its makeup in September 2015.

S&P/TSX Industry Weights (%)		
	Sept '05	Sept '15
Energy	**27.1**	**18.5**
Producer - Related	23.3	11.5
Transport - Related	2.8	6.6
Materials	**14.4**	**9.0**
Chemicals	1.9	2.7
Base Metals	5.4	0.8
Gold & Silver	4.9	4.4
Paper & Forest	0.9	0.5
Financials	**30.7**	**37.2**
Banks/Insurance	26.5	30.2
Real Estate	**0.4**	**5.3**
S&P/TSX -Other (%)		
Biovail/Valiant	0.4	4.6
Nortel/RIM	2.8	0.2

Four comparisons are striking. First, and to no surprise, has been the implosion in the Energy and Materials weights of the index. From 41.5% of the market in 2005, these primary commodity sectors have fallen by a third, to 27.5% today. Second, and directly related, has been the collapse of the two largest commodity subsectors, those related to Oil Production and Base Metals. In 2005, Canada had three of the world's premier base metal companies, Alcan, Inco and Falconbridge. Today they are gone, having been absorbed into the global mining conglomerates Alcoa, Vale and Xtrata. Our Oil and Gas Producers component has been halved (unfortunately, not by takeover), as a result of poor oil prices and to some degree, changed business models. Third, Real Estate has become an "investible" sector in Canada as publicly traded real estate firms have made a significant jump in capitalization. Finally, one-off names like Valeant (formerly Biovail), as a result of significant acquisition activity and perhaps a bit of tax optimization, have risen out of nowhere. By comparison, the previous decade's darlings, Nortel and Blackberry (RIM), are virtually non-existent today.

What does this mean going forward? As contrarians, we are fascinated by the fact that Valeant had a market capitalization almost equal to that of the Gold and Base Metals sectors. A little mean-reversion and our beaten down Materials sector could be a world outperformer once again. Second, the Chemicals weighting of the TSX consists of two of the largest fertilizer companies in the world, Potash Corp and Agrium. These global leaders should catch a bid when the commodity sector comes back to life. Finally, in the Energy sector, the Transport-related stocks are now much more than long-haul pipelines. These intermediate companies have solid business models with steady cash flow, hallmarks of good investments.

Today, the Canadian equity market represents about 3 1/2% of the worldwide equity marketplace, about the same level of 10 years ago. Over the past 10 years, global asset allocators have avoided commodity countries like Canada. With a glimmer of global growth, a reversal of the $US, or even some corporate acquisition buying, it is, in our view, a wonderful time to seek out opportunities with the cash we hold.

Vestcap INVESTMENT MANAGEMENT INC.
vestcap@vestcap.com