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Mackenzie GLC team

Oh Canada! A case for optimism in Canadian active management

Global Equities

Introduction

The core feature of any market-weighted index is that its returns are linked directly to its largest members by market cap. Any passive investor or allocator to that index, by definition, will have their prospective returns similarly linked to those major constituents. These major constituents in turn are a feature of the history of that market itself.

In Canada, index investors are likely aware that Canadian markets have languished compared to other developed markets in recent years, a function of the nation's history as well as the history of its major index constituents. Canada and its primary exchange were built on the foundation provided by its strong and well-regulated financial system and abundant natural resources. These capital intensive and mature businesses, which make up significant portions of the Canadian indexes, are closely linked with macroeconomic variables on both a local and a global basis. A heightened focus on environmental, social and governance (ESG) issues and related funds flows are also a consideration.

This leads to the perception that to earn adequate returns in a low yield or growth backdrop, investors must allocate elsewhere. This problem is even more acute for the passive investor.

We argue that this is not the case. We advocate active management among Canadian equities, as we believe it offers the potential to generate attractive returns in the more dynamic names that are obscured by history as represented by the major market components.*

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* Data used in this paper for charts displaying shares, indexes and sectors were calculated with total shareholder returns.

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The history of the TSX is rooted in Canada's history

To frame why Canadian returns have lagged in the past decade and where opportunities may lie, it is instructive to look to history. A market index is a function of the economy of the host nation, and the businesses that are attracted to list on that market. This introduces some element of chance and serendipity in how any country's reference index is structured over time.

It will come as little surprise that Canada's history as an exporter of commodities is reflected in the history of Canada's signature index, the TSX. While different commodities or exports have ebbed and flowed in terms of their weight in the index, the banks that financed these businesses and the companies that moved product, people and information in the nascent country have endured.

This enduring history is celebrated in a well-known picture of the final spike of the Canadian Pacific Railway being driven home in November 1885. The man given the honour was Donald Alexander Smith, a vice president of the Bank of Montreal, showing this lasting partnership between finance and industry in Canada. The event highlights another feature of the TSX, both BMO and CP, founded in 1817 and 1881 respectively, remain heavily represented in the TSX over a century later.

In fact, today's TSX still echoes the very early markets in Canada when utilities, railways and financial intermediaries were heavily represented on the Toronto and Montreal exchanges.[1] One could observe that this is logical as Canada's resources needed to be extracted (energy, mining and agriculture), brought to market (rails, pipelines) and produced (autos); with all of those industries requiring people and financing (banks and insurers) as new technologies or trade agreements shifted Canada's exports. Finally, a sparsely populated country led to a lack of competition and the rise of regional oligopolies in utilities, telecoms and even grocery.

Today's TSX still echoes the very early markets in Canada when utilities, railways and financial intermediaries were heavily represented on the Toronto and Montreal exchanges.

It is with some irony that we note that the Toronto Stock Exchange ("TSE") initially avoided resource issues given the view that mining shares were "too speculative, risky, or short-lived." The result was the Toronto Stock and Mining Exchange ("TSME"), a specialized exchange from its inception in 1896 until its merger with the TSE in 1934. The years after the crash of 1929 leading up to the merger were formative for modern Canadian markets in two ways:

1. The price of gold was raised by President Roosevelt from $20 in the post-Depression era to $35 by executive order in a stimulative response to the weak economy, leading to increased trading volumes on the TSME and contributing to the merger.
2. Regulators were generous, as "between 1930 and 1935, nine of the ten largest banks in Canada (all of which survived the Depression) were technically insolvent at some point."[2]

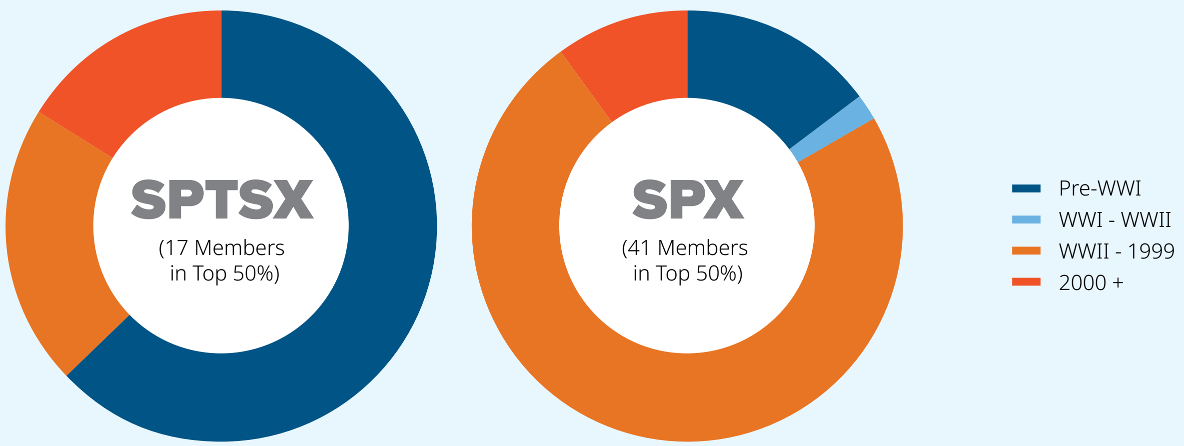
This period was formative in establishing a market that was open to resources and protective of the banks, while trading volumes in the gold market of the era contributed to cementing the TSE's position as a leading Canadian exchange versus its rival, the Montreal Stock Exchange.

1 Robert Sweeny, Dept. of History, Memorial University of Newfoundland, https://opentextbc.ca/postconfederation/chapter/8-3-capital-markets/
2 Darren Karn under direction of Professor Joe Martin, 2012, How Toronto Became the Financial Capital of Canada: The Stock Market Crash of 1929, Rotman School of Management CASE STUDY. His citation to follow was 'Brean et al, 253' https://www.rotman.utoronto.ca/-/media/Files/Programs-and-Areas/CanadianBusinessHistory/Stock%20Market%20Crash%20of%201929_UPDATED.pdf

Today's reflection of history and comparison to the SPX

The dynamics described above contributed to a market more heavily concentrated in the largest and oldest businesses of Canada. When compared to our closest neighbour's marquee index, the S&P 500, the TSX as measured by market cap is, shall we say, mature, as show in the Figure 1 below.

Figure 1 | SPTSX vs SPX By Year Founded (Top 50% of Both Indexes By Market Cap)



Source: Bloomberg

This maturity has led to a Canadian market being dominated by large incumbent or capital-intensive businesses linked to global or local economic growth. This can be an issue for investors today as these businesses can be more susceptible to non-controllable factors such as the growth rate of the economy, interest rates or commodity markets. Historically, this has been in Canada's favour for long periods of time. From 1999 to 2008 for example, a recovering global economy and rapidly growing Chinese economy led to significant demand and price increases for commodities and energy produced by TSX listed companies.

While a new commodity cycle is possible, technological improvements in renewables and electric vehicles, a global focus on the climate and increasing recognition and pricing of ESG factors, with corresponding SRI funds flows, all suggest that Canada's economy and index needs to adapt and diversify beyond its roots in resources.

This contrasts to the US index which, although still showing signs of history in financials and resources, exhibits a higher representation of younger companies built on exporting brands, intellectual property (IP), or health care. Businesses that in general have lower cyclicality, are more scalable and have higher growth potential.

Concerns that Canadian market return potential is limited by maturity or cyclicality ignore signs of optimism that are obscured by Canada's largest companies. Importantly, we note the emergence of newer Canadian exports in tech/IP, brands, niche industrials, acquirors and renewable energy. Businesses in these areas may contribute to a narrative that is shifting to growth from a legacy in extractive resources.

One notable case for enthusiasm that positive shifts are underway is Shopify, which has rapidly grown to a leading weight in the TSX with a scalable businesses model and positive stakeholder impacts. Shopify's 2019 Sustainability and Economic Impact reports highlights these impacts as it works towards "building a 100-year company." [3]Specifically, in 2019 Shopify-powered businesses employed over 2.1 million people, generating $136 billion in global economic activity, not only in Canada but across developed and emerging markets. The company also made a formal commitment to environmental initiatives with a minimum of $5 million annually (tied to revenue growth), provided free or support for education for entrepreneurs and youth, as well as participating on initiatives to further indigenous economic reconciliation and well-being. Another notable success story was lululemon, which if it had remained on the TSX (still headquartered in Vancouver) at a $60 billion CAD cap, would have a similar weighting to CP or BMO.

Our country has the creativity, people and capital to incubate new global businesses.

Market structure and a lost decade of returns

The history of Canada we've described and the market structure it influenced has led to a decade of mediocre returns, which we believe has obscured signs of optimism in the small and mid cap opportunity set in our domestic markets.

The sector-based differences between the TSX and the SPX were stark entering 2010 and are highlighted in Figure 2. Following the global financial crisis (GFC), resource markets had recovered quickly into 2010, while financials had similarly stabilized near pre-crisis levels. The result was the familiar Canadian concentration in three mature sectors heavily reliant on external factors.

The SPX entered the decade with a much different structure and outlook given a more diversified market by sector representation as well as information technology holding the largest weight in the index.

For Canada – the last 20 years have been a "tale of two decades" as shown in following Figures 3 and 4 as the performance in commodities and tech essentially flipped.

Figure 2 | 2010 Market Structure

Sector - 2010	TSX	SPX	Net
Financials	28%	16%	12%
Energy	27%	12%	15%
Materials	24%	4%	20%
Industrials	5%	11%	-5%
Comm. Serv.	4%	3%	1%
Info. Tech.	2%	19%	-16%
Discretionary	4%	11%	-6%
Utilities	2%	3%	-2%
Cons. Staples	3%	11%	-8%
Real Estate	0%	0%	0%
Healthcare	1%	11%	-10%

3 https://news.shopify.com/shopify-releases-2019-sustainability-report-and-economic-impact-report

Figure 3 | Return History 2000 - 2010

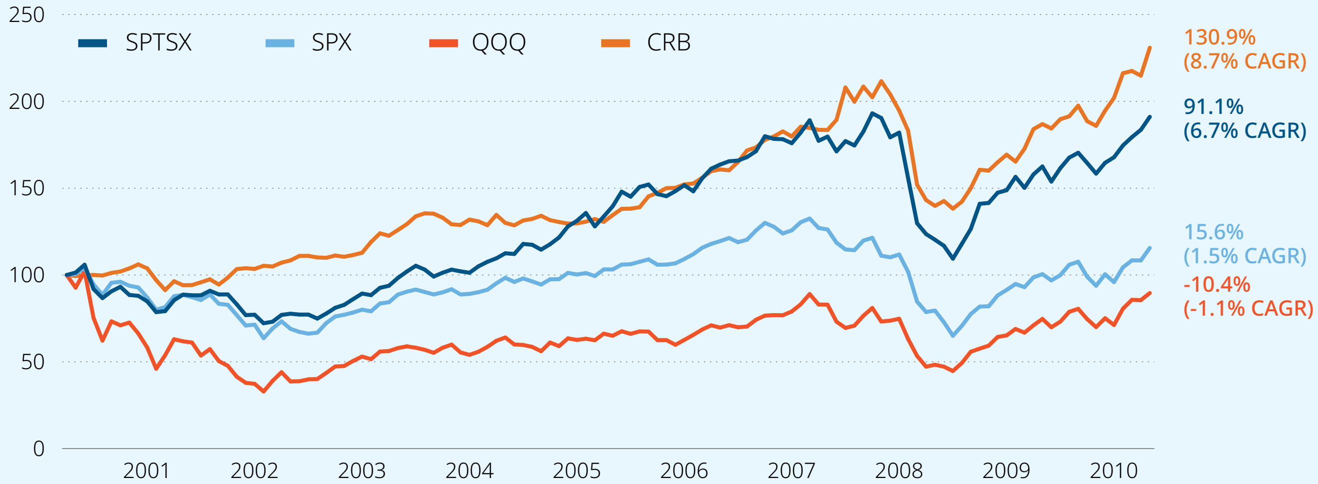
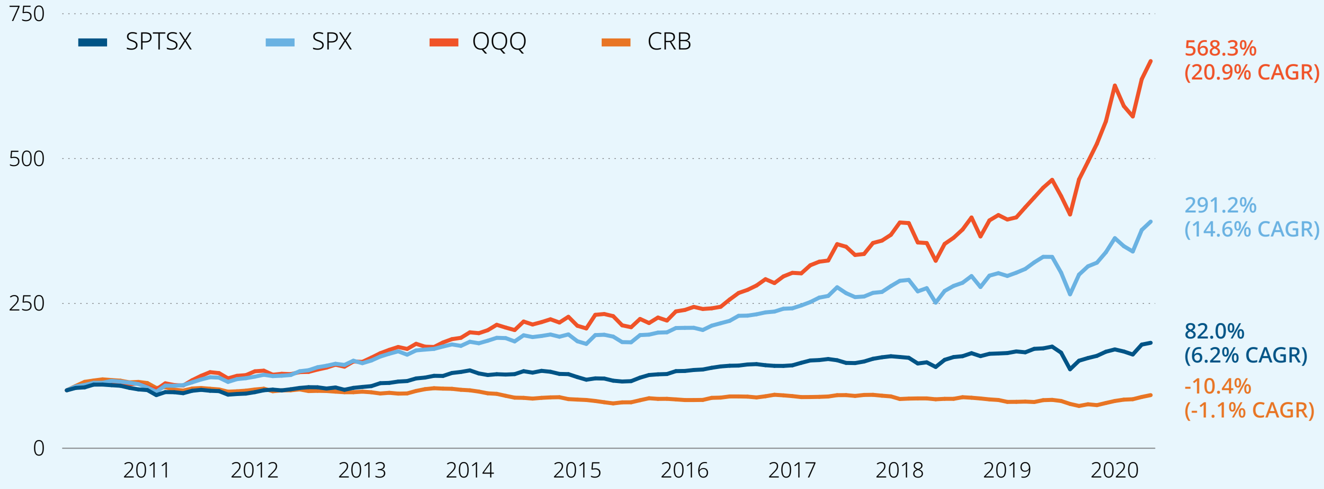


Figure 4 | Return history 2010-2020



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What's the point?

The readthrough from the above discussion may be obvious: the SPX's largest core sectors and companies have been well-suited for the environment following the GFC. Persistent stimulus, anemic global economic growth and growing appreciation for the scalability and durability of growth for technology and brands has contributed to significant multiple expansion, while the stability and pricing power of health care companies has also been well-rewarded.

Core features of these outperforming sectors have been secular versus cyclical traits with high growth, technology, economies of scale and a higher mix to intangible assets such as IP and brand, whereas Canada was dependant on the banks (and their yields) for more than half of its returns. Canada's legacy in resources was also at play with the cyclical impacts of the exposure turning broadly negative for Canadian equities after the much happier 1999-2010 period.

Observers of the markets will not be surprised that two of Canada's largest sectors from 2010-2020 also had the weakest returns in the index over the decade. Canada began the decade as a key provider of energy to the US and China with reference prices trading in the range of $90 to $100 from the recovery of the GFC into 2014. Since 2014 into 2020 the oil market fundamentals have been beset by a series of headwinds. While the TSX and SPX were impacted significantly by energy (a top three index representative in both markets at the onset of the decade) the relative diversity of the SPX and significant weight to the top performing sector of the decade were the key differentiators.

Conversations on investing in Canada therefore shift to discussions around value or yield opportunities for bargain hunting in financials and energy, familiar cyclical trades while a new commitment to inflation targeting and monetary stimulus reinvigorates the bid for the TSX's gold issues.

While the data presented appears stark for prospective returns, the TSX is beginning a new decade with greater diversity and nascent signs of positive shifts in the TSX and beyond (small cap/venture). While it may take time for these businesses to achieve the scale that would make them meaningful components of the TSX, active managers can potentially take advantage today.

So where do we think the opportunities lie in Canada? Think smaller

A simple exercise can highlight the potential of Canadian companies and equities for investors and allocators willing to dig deeper. Figure 5 compares the total returns of the TSX over the past 10 years to an equal-weighted analysis of today's members over that period.

The chart shows succinctly that there have been stronger performers beyond Canada's largest index weights, while Figure 6 below shows the odds of selecting winners from the TSX members over the past decade within sectors. Notably the attractive sectors mirror the positive themes more evident in the US market:

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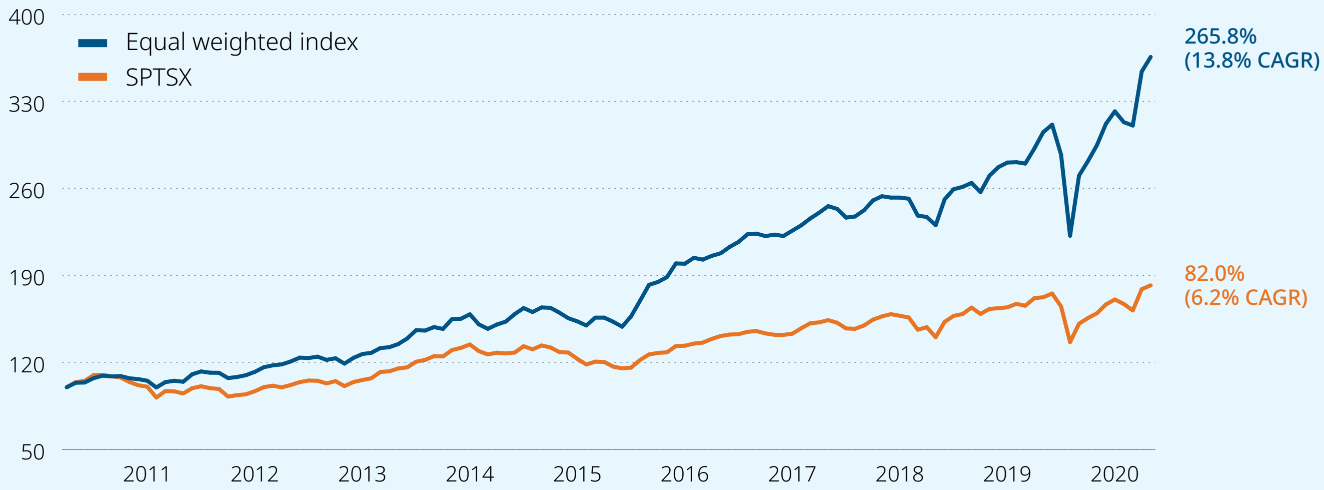
Figure 5 | Equal Weighted vs. SPTSX 10-Yr. History (Rebalanced Monthly)



S&P/TSX total returns compared to the equal weighted returns of today's TSX members over the timeframe.

Figure 6 | TSX Performance by GICS Sector

TSX Performance By GICS Sector				TSX CAGR	5.7%	
Sector	**# of Outperform**	**# of Underperform**	**Total**	**Hit Rate**	**Average Up**	**Average Down**
Energy	16	74	90	18%	17%	-20%
Materials	32	83	115	28%	29%	-15%
Industrials	27	12	39	69%	18%	-11%
Cons. Disc.	21	6	27	78%	21%	-12%
Cons. Staples	12	1	13	92%	15%	4%
Health Care	7	10	17	41%	21%	-13%
Financials	22	11	33	67%	13%	-1%
Info. Tech.	11	4	15	73%	44%	-5%
Comm. Serv.	9	4	13	69%	11%	-4%
Utilities	13	6	19	68%	15%	-5%
Real Estate	24	11	35	69%	15%	0%

Based on 416 members as at the beginning of each calendar year over the past 10 years.

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Looking to the changes in the members of the TSX over the last decade in Figure 7, you can see the evidence of the positive shifts and rejuvenation we have alluded to within the market.

We can define buckets of securities, namely "Legacy' names being persistent through the time period, and "Graduates" and "IPOs" being new entrants. We can then define exits from the index being either positive in the case of a "Takeout", or negative when a listing was "Demoted" or "Bankrupt", and finally "Takeunders" being names consolidated below prices in place at the beginning of the analysis period.

Legacy members of the TSX have provided positive returns on average, but much higher returns were available to companies identified early that graduated onto the TSX, while new IPOs and Take-outs were significant at >10% of names. Exits overall were skewed negatively, with significant losses for takeunders, demotions and bankruptcies, concentrated in resources.

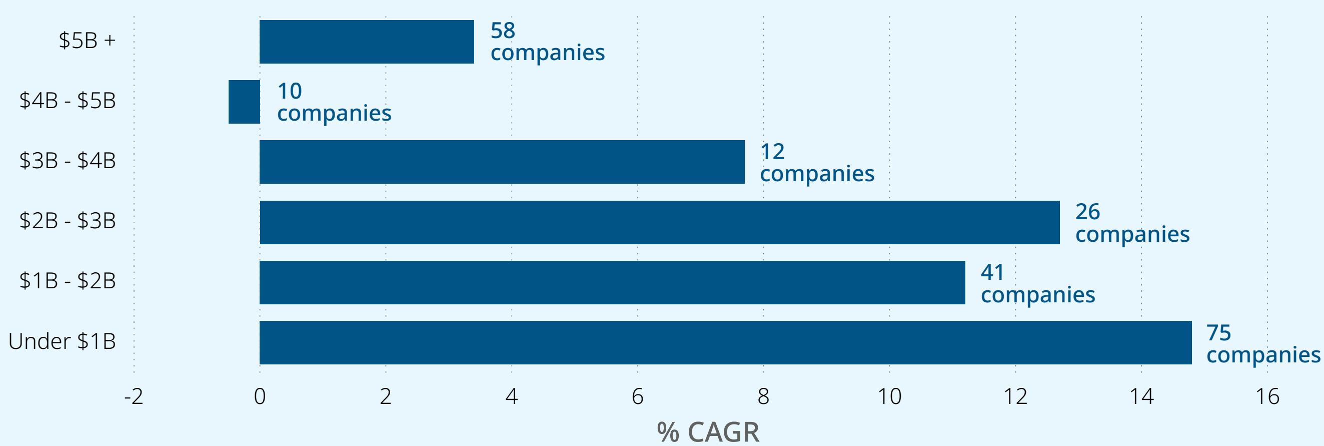
Presented differently in Figure 8, there are further signs of optimism for a smaller cap investor.

Figure 7 | TSX Member Shifts Over 10 Years

Type	Total	Avg. CAGR	Avg. Total
Legacy	124	5.5%	134.0%
New			
Graduate	56	17.0%	570.6%
IPO	42	18.0%	305.9%
Exit			
Takeout	54	20.6%	95.6%
Takeunder	41	-17.0%	-52.5%
Demoted	82	-15.3%	-40.5%
Bankrupt	17	-48.3%	-77.4%

Based on 416 members as at the beginning of each calendar year over the past 10 years.

Figure 8 | 10-Year Weighted Average CAGR By Market Cap



Source: Bloomberg

These observations suggest that the small and mid cap companies in Canada may be fertile ground to look for differentiated Canadian companies with more attractive growth and return characteristics to supplement steady returns of the incumbent members of the TSX.

Some of the differentiated themes include significant outperformers (>15% CAGR) in new exports in technology and IP through both acquisition and organic growth. In this sample, Shopify, Lightspeed, Kinaxis, Constellation Software, Enghouse and Descartes have all been exceptional performers from smaller cap companies, all either new IPOs or graduates. Legacy tech names OpenText and CGI Inc. have also compounded ~20%. Another key outperforming theme has been Canada's emerging renewable energy producers with five companies namely Brookfield Renewable Partners, Boralex, Northland Power, Innergex Renewable Energy and TransAlta Renewables in the outperforming bucket.

Brands and retail included FGL Sports, the Stars Group, Dollarama, AutoCanada, Canada Goose Holdings and Restaurant Brands International. Niche industrials were a final notable bucket with Richelieu Hardware, Ritchie Bros. Auctioneers, TFI International, Badger Daylighting, Ballard Power Systems, Cargojet, and Boyd Group Services representing the new entrants into the S&P/TSX, while incumbents Canadian Pacific Railway, Air Canada, Canadian National Railway and WSP Global generated attractive returns.

An active approach can potentially capture the emerging growth names available in the Canadian market that have been obscured by history and to close the gap between the TSX's differences in market structure vs the SPX.

We can see that new entrants to the TSX through graduation or IPO in industrials, staples, technology and renewables have significantly outperformed. The challenges facing Canada's largest index members contrasts with the opportunities evident in small-mid cap Canadian companies, while pockets of Canadian incumbents continue to show the potential for steady returns if a low return environment exists.

This highlights that an active approach can potentially capture the emerging growth names available in the Canadian market that have been obscured by history and to close the gap between the TSX's differences in market structure vs the SPX.

The case for active within the Canadian market

We believe the Canadian market lends itself well to an active approach of investing in companies with greater growth opportunities, underappreciated growth prospects or sectors with lower inherent risk than the index. Conventional wisdom associating the market with high volatility and maturity may miss the returns available in Canadian companies across market caps. This line of thinking is also more commonly associated with market-like returns. All stakeholders of Canadian-listed companies may benefit from active approaches cognizant of the benefits of incorporating ESG into their process.

Our discussion of market structure highlights that there were ample opportunities for outsized returns within the Canadian market over the past decade. A piece by Martin Cremers laid out three pillars of active management serving to capture these returns. Namely these pillars were skill, conviction and opportunity, noting that "successful managers must have (1) the skill to identify good investment opportunities appropriate for their clients, (2) the right judgment or willingness to choose prudently among the identified opportunities, and (3) sufficient opportunity or lack of practical obstacles to do so persistently."[4]

4 Cremers 2017, Active Share and the Three Pillars of Active Management: Skill, Conviction, and Opportunity, Financial Analysts Journal

Cremers goes on to describe how these three pillars relate to performance in association with active share, a metric he coauthored in Cremers and Petajisto (2009). His findings are straightforward, in that active share matters, investors shouldn't overpay for low active share which in general underperforms, and the most successful managers combine high active share with long holding periods/low turnover.

In our experience his findings resonate with a long-term investment strategy where strong conviction is necessary given the intention to hold positions for the long term. It also renders the index focus of debate moot, as index considerations are secondary to selecting and sizing the best opportunities. The potential outperformance for the long term and high conviction management philosophies is supported in academia.[5]

Some allocators may have concerns on Cremers' third pillar, namely opportunity or how many investible names Canada has to offer. While we do not share that view, we do believe the first two points of skill and conviction can supersede the third pillar. Literature supports this view (as well as active versus passive). Bessembinder, Chen, Choi and Wei (2019) noted the concentration in long-term returns of equities in a relatively small number of stocks concluding that "the positive mean excess return for the broad stock market is driven by very large returns to a relative few stocks, not by positive excess returns to typical stocks."[6] The paper also cites the body of work showing a positive skew to stock returns, "particularly when compounded over longer time horizons."

Throughout the illustration of the market structure in Canada we detailed ample opportunity has existed for managers with conviction, skill, prudence and opportunity to earn attractive returns, and well in excess of the broader reference benchmark in names that compounded significantly over the 10-year period. The noted association of skill with concentration addresses the sector concentration issues at the index level when there is a focus on capturing the best risk-adjusted returns.

Potential for further benefits of "Active" In Canada.

We believe there are also ancillary benefits to active managers in Canada in more appropriately allocating capital to higher potential names, engaging with management teams to promote positive corporate citizenship and creating a receptive index for nascent growth names.

We argue that the Cremers findings particularly in skill and conviction, associate well with a long-term investment strategy or what we describe as an owner's mindset. Skill in selecting Canadian names with characteristics that can be associated with extended growth curves as well as smart and well incented managers, while incorporating broader stakeholder impacts in their decision making can act as both a risk mitigator and return enhancer, all promoting conviction.

The owner's mindset can also be described as allocating capital with an awareness or commitment to improve on matters of ESG, with a growing body of work that supports what historically would have been considered as best practice to incorporate into a well-rounded investment decision. McKinsey notes that the "overwhelming weight of accumulated research finds that companies that pay attention to environmental, social, and governance concerns do not experience a drag on value creation," and actually correlates with higher equity returns and a reduction in downside risk.[7]

5 Shleifer and Vishny (1990, 1997)
6 Bessembinder, Chen, Choi and Wei 2019, Do Global Stocks Outperform US Treasury Bills?*,
7 Henisz, Koller and Nuttall, Five ways that ESG creates value (McKinsey & Company, 2019).

Practitioners have also highlighted these traits, RBCAM found that "Skill and expertise need to be developed to assess nuanced factors such as corporate culture, employee engagement, customer satisfaction, the business's social licence to operate, maintenance and safety procedures, R&D effectiveness, brand and reputation, and these will vary from industry to industry and will also shift over time."[8] All information that is also more difficult for quantitative and qualitative methods to capture and incorporate into positions and sizing, and shows the linkage between incorporating ESG considerations into both risk management and identifying qualities associated with better risk adjusted returns and opportunity for alpha.

This leads to a refreshing conclusion — Canadian allocators have opportunities to invest with managers who can potentially earn attractive returns while supporting Canadian companies that best represent our country and unitholders, or companies with a commitment or opportunity to improve as responsible corporate citizens. Perhaps an argument stands for active both for returns and to improve societal outcomes.

Why Canadian small and mid cap companies?

Canadian small and mid cap companies have contributed strong performance and we believe are creating new options for large cap investors as they mature and scale within Canada and new international markets. We also ascribe to the wide body of research showing support for investment in small and mid cap companies given less analyst coverage, liquidity, as well as less competition in the space given the size and liquidity of these companies.

These younger companies as we've shown have also been able to generate attractive returns versus larger Canadian companies as they extend growth curves organically, through acquisitions or are themselves acquired. We have also shown that while there may be an association with cyclicality in Canadian small and mid cap companies, there are in fact many investible themes available within the market cap.

Why the Mackenzie GLC team?

On the Mackenzie GLC team, we believe that there are inherent qualities to companies and investments that can be associated with the long-term compounding of returns at lower risk. This blends filtering for attractive fundamentals of the businesses we own with a focus on growth potential, balance sheets and returns on capital. We then expand the analysis to the qualitative aspects that can extend growth curves, including the people and incentives motivating the stewards of these businesses, their impacts on stakeholders and our unitholders capital. These philosophies give us the confidence to take meaningful positions in companies where we believe we can be owners for the long-term.

We believe that there are inherent qualities to companies and investments that can be associated with the long-term compounding of returns at lower risk.

8 Subjally 2019 – The evolution of active management, RBC Global Asset Management

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Conclusion

The lackluster returns of the past decade for Canadian benchmarks obscure the attractive opportunities we believe are available in our markets to investors willing to take an active approach. A look into Canada's history and the current structure also shows signs of a positive shift under the surface of the TSX to new exports in IP, brands, niche industrials and renewable energy, supplementing steady returns from mature businesses.

In the Mid Cap Canadian Equity mandate, we seek out Canadian companies with outsized growth opportunities not only in Canada, but also globally. We are proud to partner with and support companies and teams that are creating positive outcomes for their stakeholders and our clients through qualities that we associate with positive long-term risk adjusted returns. In our experience this active approach has led to excess returns and is well supported by the shifts in Canadian markets over the last decade.

Bryan Shearer, CFA, Associate Vice President, Portfolio Manager

Bryan joined Mackenzie in 2021 through the acquisition of GLC Asset Management (GLC). Bryan is the lead portfolio manager for the Canadian Mid Cap equity mandate. Bryan became a key member of GLC's Canadian equity team in 2001. For over a decade he has worked with the Canadian Mid-Cap portfolio management team where he developed expertise and in-depth knowledge of this unique sector of the Canadian market. Bryan is a CFA charterholder and earned an Honours Bachelor of Commerce degree from the University of Manitoba.

Erik Sjoberg, CFA, Associate Portfolio Manager

Erik joined Mackenzie in 2021 through the acquisition of GLC Asset Management (GLC). Erik joined Mackenzie in 2021 through the acquisition of GLC Asset Management (GLC). Erik began working exclusively with the GWLIM team in 2009. Since 2013, Erik's focus has been on the GWLIM Canadian Mid-Cap mandate. Erik has an honours bachelor of commerce degree from the Asper School of Business at the University of Manitoba and is a CFA charterholder.

Rob Wiens, Associate Investment Analyst

Rob joined Mackenzie in 2021 through the acquisition of GLC Asset Management (GLC).Rob joined GLC in September 2018, working with the Canadian Mid-Cap Team. Rob graduated from the Asper School of Business at The University of Manitoba with a Bachelor of Commerce degree majoring in Finance. Rob has passed all three levels of the CFA program and may be awarded the charter upon completion of the required work experience.

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