

Canadian equity allocations in institutional portfolios



The equity allocations of Canadian institutional investors have evolved considerably over the past decade, with the global equity component increasingly comprising the biggest portion of the total equity allocation.¹ This shift has been funded in significant part by shrinking allocations to Canadian equities; in some institutional portfolios, Canadian equity allocations have disappeared entirely – a dramatic change from the 2000s, when foreign content in Canadian pension plans was still restricted.

While there is sound reasoning behind this trend in allocations, the purpose of this paper is to argue that from today's starting point, the outlook for Canadian equities over the next decade is attractive relative to global equities, and in particular, U.S. equities, which make up nearly 70% of the MSCI World Index.² In an upcoming paper, we will make a similar case for allocations to emerging markets (EM) equities. We believe there is a strong case for many Canadian institutional investors to consider increasing, or at least stop reducing, the allocations to Canadian equities in their portfolios.

Relative performance

To inform our forward-looking expectations, it is helpful to look back and consider: How have Canadian equities performed relative to their U.S. or global counterparts over the long term? For this particular comparison, the answer is highly dependent on the time period.

From December 1969 through September 2023, the MSCI World Index outperformed the S&P/TSX Composite Index by 0.2%, earning 9.2% compared to the Canadian market's 9.0% (in Canadian dollar terms, before any costs associated with implementing these investments). However, if we adjust the time period to an end date ten years earlier, the results are quite different: from December 1969 through September 2013, the S&P/TSX outperformed the MSCI World Index by 0.6%, earning 9.3% over the period relative to the global market's 8.7%.

The reason for this dramatic end-point sensitivity is that the relative returns of the two indices tend to be very streaky, with long periods of relative out- and underperformance stemming from both sector composition and currency effects.

Figure 1: Canadian equities vs. global equities – indexed performance Dec 31, 1969 to Sept 30, 2023



Source: RBC GAM. All returns in CAD. December 1969 to September 2023 Note: Canadian Equities are represented by S&P/TSX Capped Composite Index. Global Equities are represented by MSCI World Index (CAD).

¹According to the Coalition Greenwich Voice of the Client 2022 Canadian Institutional Investors Study, Canadian equities comprised 12% of the portfolios of institutions between \$501-\$999 million in assets, while global equities comprised 31%. Smaller plans tended to have slightly more Canadian equities, while the largest plans had less.

²MSCI, as at September 30, 2023.

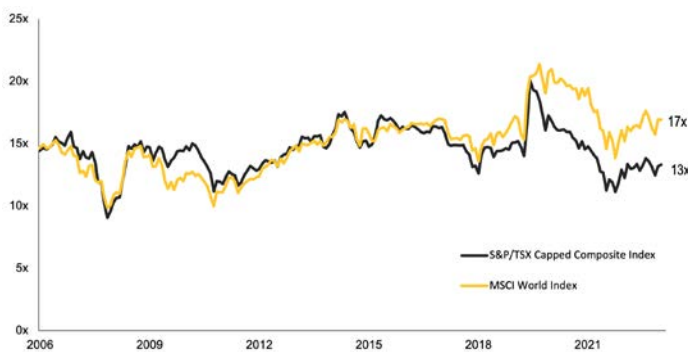
Considering Figure 1, the periods of relative out- and underperformance are closely linked to the commodity markets and to the technology sector. For example:

- Through the Great Inflation of the 1970s, Canadian equities benefitted from the local market's heavy weighting in natural resource equities.
- Over the next twenty years, Canada underperformed as commodity prices deflated, and U.S.-listed technology stocks gained in market importance through the 90s, culminating in the dot-com bubble.
- Through the 2000s, as China joined the World Trade Organization and industrialized, it consumed increasing volumes of natural resources and drove commodity prices back higher, and Canadian equities once again benefitted from their exposure to these sectors.
- More recently, Canada has underperformed as commodity prices traded flat to down, while technology stocks once again took on a more prominent role in markets.

Just as the sector makeup of the Canadian and global equity markets has had a meaningful impact on their relative performance to date, we have good reason to believe that their particular sector biases will continue to influence their relative performance when considering today's valuation starting point.

Earnings and valuation

Figure 2: Forward P/E of S&P/TSX Capped Composite Index and MSCI World Index



Source: Bloomberg, RBC GAM. As of Dec 5, 2023.

As shown in Figure 2, the Canadian and global equity markets generally trade at similar valuations (as measured by the price-to-earnings ratios of the two markets). Recently,

however, a valuation gap has opened up between the two geographies, creating what we believe is an opportunity. While this gap has existed for some time already, and the timing of its closing is difficult to predict, it is likely to close over the multi-year investment horizons of institutional investors.

In Canada, the Financials and Energy sectors make up half of the S&P/TSX's earnings, and the relatively low earnings multiple reflects the market's assessment of the near-term outlook for both of those sectors.³ While the market is anticipating that Canadian bank earnings will face higher credit losses as they absorb the effects of higher interest rates and a possible recession, valuations for the group have compressed to approximately 10x earnings estimates, estimates that already reflect a significant increase in credit loss provisions. While it is possible that earnings could decline further in a scenario of even worse credit stress than expected, the banks have more than adequate capital to weather that storm, while maintaining dividends.

As for the Energy sector, under the current WTI oil price of approximately U.S.\$70, the sector is generating large amounts of excess free cash flow, and we estimate would continue to do so even if the oil price were meaningfully lower – particularly the large cap companies that represent large index weights. We expect that the sector will need to fund a significant investment in carbon capture and storage in the coming years, but believe it will generate more than adequate cash to fund this.

The global equity investment universe, by contrast, has much more exposure to the currently exciting Information Technology sector. Today, seven technology companies with leadership in AI – coined the Magnificent Seven – have grown to represent 27.5% of the S&P 500 Index, and 18.4% of the MSCI World Index.⁴ While the long-term earnings growth opportunity for these companies is likely greater than for Canadian banking and energy, this is already discounted in their share prices to a significant extent. A simple analysis in our Fall 2023 Global Investment Outlook estimated that if the rest of the market grows its earnings at the historic rate of 6.2% over the next decade, these companies would need to grow their earnings by 36% annually over the next ten years in order to justify their premium.⁵ While not impossible, this suggests the bar is set extremely high and these companies could be vulnerable if they were to disappoint investors' expectations, potentially weighing heavily on major global equity indices.

³ RBC GAM

⁴ Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta, as at September 30, 2023.

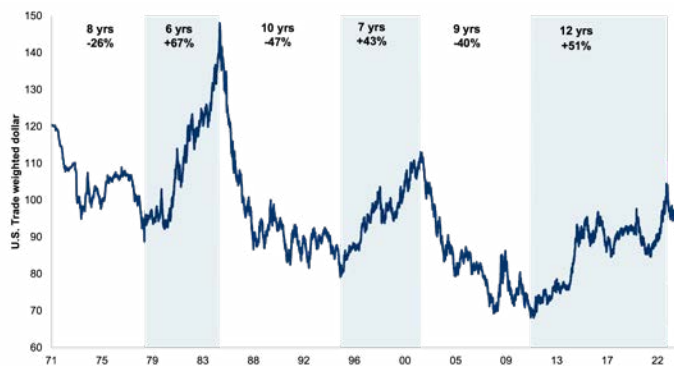
⁵ See Appendix 1.

Currency effect

A significant component of the relative returns of the Canadian and global equity markets is the effect of currency, in particular the trend in the U.S. dollar relative to other global currencies, including the Canadian dollar. U.S. equities represent almost 70% of the MSCI World Index as of September 2023, so movements in the USD relative to the CAD are a significant driver of the returns experienced by Canadian investors.

As the chart below shows, the USD tends to move in long, multi-year cycles relative to other currencies. These cycles tend to coincide strongly with the relative performance of U.S. (and by extension, global) equities relative to Canadian equities.

Figure 3: U.S. trade-weighted dollar



Note: As at Oct 13, 2023. Source: RBC GAM, Bloomberg, U.S. Federal Reserve.

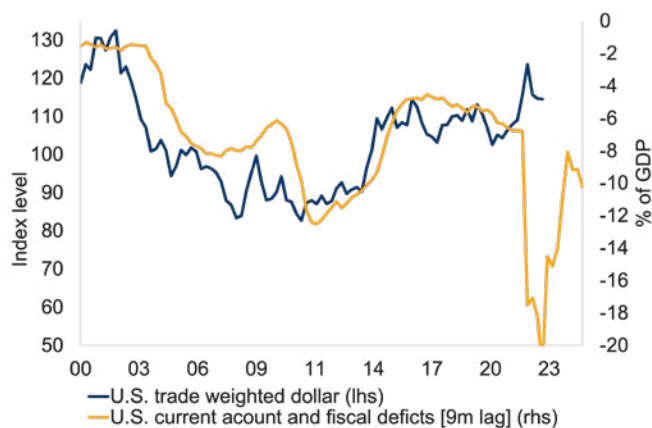
RBC Global Asset Management’s currency team’s view is that the long-term trajectory for the U.S. dollar is lower. The team’s outlook – covered in more detail in their Fall 2023 Global Currency Outlook – is excerpted here:

We expect a multi-year period of weakness to exert an important influence on bond, equity, commodity, and currency markets. Most valuation models indicate that the currency has been expensive for several years, and the purchasing power parity model that we monitor places the dollar at more than 20% rich to its estimated fair value. Likewise, few would contest the link between America’s deteriorating fiscal and trade deficits and U.S.-dollar movements (Figure 4) or the negative U.S. dollar implications from U.S. bank failures, threats of government shutdowns and credit-rating downgrades. Finally, the theme of “de-dollarization” – a slow but gradual shift away from using the U.S. dollar for global trade and global investment – has gained traction. The theme will erode support for the dollar over the next decade, especially if the U.S. continues to weaponize the currency by restricting access to payment systems and freezing the foreign-exchange reserves of its enemies.

A simple reversion of the USD/CAD exchange rate from the 1.38 level of September 2023, back to the current purchasing power parity level of 1.15 (the midpoint of the bands shown in Figure 5) – even if spread out over the next decade – would add a meaningful tailwind to the relative performance of Canadian equities.

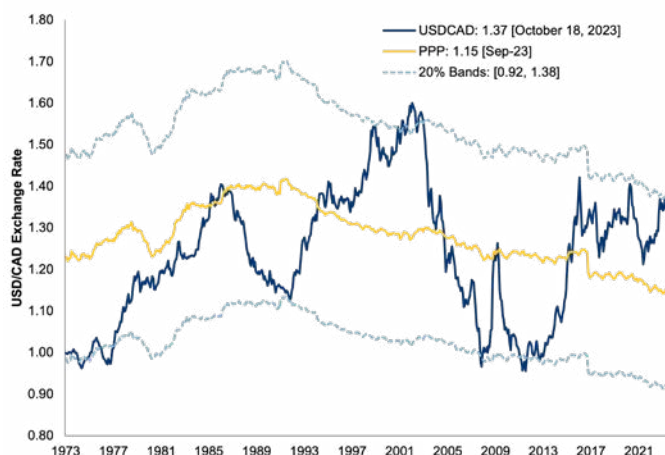


Figure 4: U.S. dollar and the American twin deficits



Source: RBC GAM, Bloomberg. As at March 31, 2023.

Figure 5: USD/CAD current purchasing power parity (PPP) valuation



Source: RBC GAM, U.S. Federal Reserve, Bloomberg.

Conclusion

While forecasting relative performance over the next year is an inherently fraught exercise, it is somewhat easier to model expected performance over the ten-year-plus time horizon over which institutions make allocation decisions. Under the Capital Markets Assumptions that we use in our portfolio modelling,⁶ we currently estimate a return of 9.1% on Canadian equities, compared to 8.2% for global equities, over the next ten years. While there is substantial uncertainty around these estimates, and the timing of this relative outperformance is very difficult to estimate, we believe the setup for strong relative returns on Canadian equities over an institution's investment horizon is attractive.

⁶See Appendix 2.



Appendix 1

Earnings rate required for Magnificent Seven to justify their premiums.

Assumptions for study

As of July 31, 2023

| | S&P 500 ex. Mag-7 | Magnificent-7 |
|---------------------------|-------------------|---------------|
| Price | 100.00 | 100.00 |
| P/E | 17.71 | 35.04 |
| Trendline EPS | \$187.30 | \$36.38 |
| Trendline earnings growth | 6.19% | 17.93% |
| Discount rate | 6.35% | 6.35% |

Earnings growth required to justify Mag-7 premium

As of July 31, 2023

| Years | S&P 500 ex. Mag-7 earnings | Cumulative earnings | Present value of cumulative earnings (S&P 500 ex. Mag-7) | Earnings growth required for Mag-7 to catch up to rest of S&P 500 (annualized) |
|-------|----------------------------|---------------------|--|--|
| 0 | \$187.30 | | | |
| 1 | \$198.90 | \$198.90 | \$187.02 | 446.7% |
| 2 | \$211.22 | \$410.12 | \$373.78 | 191.8% |
| 3 | \$224.31 | \$634.43 | \$560.25 | 121.1% |
| 4 | \$238.20 | \$872.63 | \$746.46 | 88.9% |
| 5 | \$252.96 | \$1,125.59 | \$932.40 | 70.7% |
| 6 | \$268.63 | \$1,394.22 | \$1,118.06 | 59.0% |
| 7 | \$285.27 | \$1,679.48 | \$1,303.45 | 50.8% |
| 8 | \$302.94 | \$1,982.42 | \$1,488.57 | 44.9% |
| 9 | \$321.71 | \$2,304.13 | \$1,673.42 | 40.3% |
| 10 | \$341.64 | \$2,645.77 | \$1,858.01 | 36.7% |
| 11 | \$362.80 | \$3,008.57 | \$2,042.32 | 33.8% |
| 12 | \$385.27 | \$3,393.84 | \$2,226.36 | 31.4% |
| 13 | \$409.14 | \$3,802.98 | \$2,410.14 | 29.3% |
| 14 | \$434.49 | \$4,237.47 | \$2,593.64 | 27.6% |
| 15 | \$461.40 | \$4,698.87 | \$2,776.88 | 26.1% |

Source: RBC Global Asset Management, The Global Investment Outlook, Fall 2023

Appendix 2

Capital market assumptions.

| Asset classes | Representative data series | Expected long-term return | Expected annual volatility | Expected annual downside risk |
|-------------------|----------------------------|---------------------------|----------------------------|-------------------------------|
| Canadian equities | S&P/TSX Composite Index | 9.1% | 16.8% | -26.1% |
| Global equities | MSCI World Index (CAD) | 8.2% | 14.4% | -24.1% |

Capital market assumptions represent the views of PH&N Institutional for the purposes of illustrating and understanding the potential risk-reward trade-off of different portfolio decisions and are established by considering a variety of qualitative and quantitative sources of information including: different forecasting models; internal and external research; existing and implied future conditions as priced by capital markets; and internal views of our fund managers. Expected long term annualized returns are for a 10 year forecast time horizon. Volatilities, downside risk and correlations are estimated from historical data and adjusted as required to reflect future market conditions. Investors should be aware of the limitations using forward-looking assumptions in that there is absolutely no guarantee that future performance will occur according to any explicit expectation.

This document has been provided by PH&N Institutional for information purposes only and may not be reproduced, distributed or published without the written consent of PH&N Institutional. It is not intended to provide professional advice and should not be relied upon in that regard.

PH&N Institutional takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when printed. The views and opinions expressed herein are those of PH&N Institutional as of the publication date and are subject to change without notice. This information is not intended to be an offer or solicitation to buy or sell securities or to participate in or subscribe for any service.

Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by PH&N Institutional, its affiliates or any other person as to its accuracy, completeness or correctness. We assume no responsibility for any errors or omissions in such information.

This document may contain forward-looking statements about general economic factors which are not guarantees of future performance. Forward-looking statements involve inherent risk and uncertainties, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement. All opinions in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility..

PH&N Institutional is the institutional business division of RBC Global Asset Management Inc. (RBC GAM Inc.). Phillips, Hager & North Investment Management is a division of RBC GAM Inc.

RBC Global Asset Management is the asset management division of Royal Bank of Canada (RBC) which includes RBC GAM Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, and RBC Global Asset Management (Asia) Limited, which are separate, but affiliated subsidiaries of RBC.

®/™ Trademark(s) of Royal Bank of Canada. Used under licence.

© RBC Global Asset Management Inc., 2024. Publication date: January, 2024