Laurus
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"Wide diversification is only required when investors do not understand what they are doing." - Warren Buffett

This is the third part of our series on investing in Canada. We finished off our comment last month detailing one of the many reasons larger institutional sponsors have chosen to allocate assets to other areas of the world. We contend ours is a small capitalization market, thereby limiting the dollars institutional investors can allocate to Canadian companies.

Global investors see Canada solely as a commodity allocation, given the prominence of energy and mining companies. At last count, of the 243 companies in the S&P/TSX Composite Index, 98 (40%) are either directly producing, or supplying services to, commodities, including the newest entrant, cannabis. Of the remaining companies, 25 are real estate businesses and 16 are utilities. The remaining potential investments are few in number, small in capitalization, and limited by the traditional method of sector diversification.

With so few public companies, visibility of a particular index constituent is high so the occasional mis-management of a business has considerable profile in our country. Case in point, the current SNC mess that has not only impacted the credibility of the business but has had significant impact on politicians accused of interfering in due process. Political interference certainly isn't new – former PM Brian Mulroney intervened in the David Milgaard case, forcing his Attorney General to review the case despite her reluctance to do so, resulting in the sentence being eventually overturned.

One could argue the current PM is simply reacting to the political implications of watching another major corporation leave the country along with its 9,000 jobs (and the votes attached to those jobs).

Earlier this month an article in the Globe announced the class-action lawsuit against the Royal Bank Asset Management and TD Asset Management targeting returns on their Canadian equity funds, charging that fees paid for what was regarded as index-like returns diminished investor returns. The two funds have total assets of approximately $5 billion and $2.4 billion respectively.

At the end of last quarter, the TSX Composite Index had 82 stocks under a $2 billion market capitalization. In an actively managed portfolio, a 4% investment weight of a $5 billion fund would own 10% of a $2 billion market cap company. It's not practical to assume a fund of this size can be "active" and therefore generate any significant alpha. Whether it should be considered passive with an appropriate fee we'll leave the courts to decide.

The legalization of cannabis has resulted in a surge of new companies being marketed to investors. This comes in spite of increasing evidence linking cannabis to the onset of psychosis, with high-potency strains increasing the risk five-fold. Further, shortages are now estimated to last many years, as the cost of production has been much higher than anticipated. Yet investors, both retail and institutional, have chosen to allocate capital to these truly speculative businesses, at incredibly "high" multiples of revenue, at an alarming rate.

Small risks are often overblown, but big risks are usually discounted or ignored - more people are worried about terrorists hijacking a plane than the pilot making an honest error. The big risks currently evident in cannabis investment won't end well for investors.

We constantly hear how active managers cannot add value, and that all investors should participate in the latest craze – passive investing. But is passive investing truly appropriate for individuals or institutions whose liabilities lie far in the future? That's a debate we'll leave for future commentaries, but we do suggest Canada is not an appropriate market for passive investors. Poor diversification, combined with a high number of speculative securities, makes long-term investing in a passive Canadian index vulnerable to unpredictable risks.

121 King Street West, Ste. 1820, Toronto, ON M5H 3T9 844.430.5501 (toll-free)
Laurus INVESTMENT COUNSEL