S&P/TSX Composite: Home of the "Ferocious Four"

Wealth Management
Dominion Securities

Canadian equities have lagged relative to their U.S. counterparts on a trailing 5-, 10-, and 20-year basis. However, we believe this has been a function of U.S. exceptionalism as opposed to poor performance from Canadian equities. Digging deeper, Canada is home to a collection of industries that have historically produced returns that have been on par with the S&P 500 over long periods of time. We assess the characteristics of the S&P/TSX Composite and explain why we believe investors don't have to stray far from home to generate attractive returns.

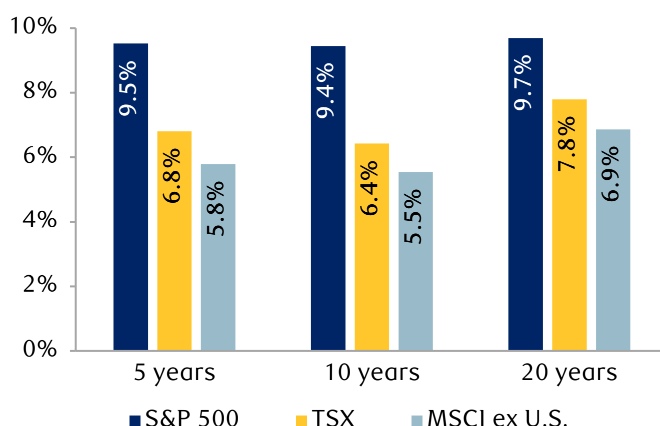
Global equities – Historical performance

Over the past 20 years, the S&P 500 compounded returns at a rate of about 9.7% per annum. For context, had someone invested $100 at day one, it would be worth approximately $637 today (total return of about 537%). Comparatively, a $100 investment into the S&P/TSX Composite would have yielded approximately $449 (total return of about 349%), At first glance, one might conclude that Canadian equities have simply delivered poor returns. However, if we contrast the returns to the MSCI World Index ex-US, we see that Canadian equities have modestly outperformed global equities. Put differently, we'd argue that it's been more a story of U.S. exceptionalism rather than lackluster Canadian equity returns.

Market composition

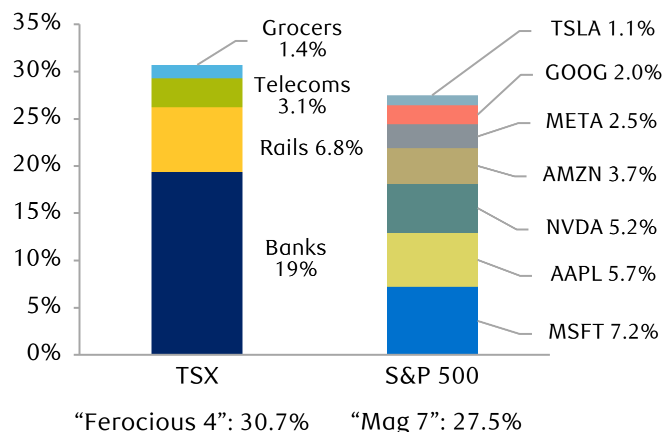
Investor interest in the "FANG" (Meta [Facebook] Amazon, Netflix, and Alphabet [Google]); "MANGA" (Meta [Facebook], Amazon, Netflix, Alphabet [Google]), and Apple) or more recently the "Magnificent 7" (Amazon, Alphabet [Google]), Apple, Meta [Facebook], Microsoft, NVIDIA, and Tesla) stock groups has surged, driven in part by strong share price appreciation. These businesses command a level of industry dominance (e.g., search, social media, and advertisement) that is virtually non-existent in most parts of the markets. These groups have benefitted from characteristics such as high barriers to entry, high switching costs, a loyal customer base, and pricing power, amongst others. In aggregate, these attributes have transformed the "Magnificent 7" into

Historical CAGRs of global equities



Source - FactSet; data range 2003–2023

Concentration of S&P/TSX Composite and S&P 500



Source - FactSet, Bloomberg; percentages do not total 30.7% and 27.5% due to rounding; data as of 3/20/24

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global powerhouses and have allowed the group to generate what we view as very attractive economics.

While there aren't any popularized acronyms for Canadian companies, Canada is home to several industries that enjoy similar characteristics. These include the diversified banks; the incumbent telecoms (BCE [BCE], Rogers Communications [RCI], and TELUS [T]); the grocers (Loblaw Companies [L], Metro [MRU], Empire Company [EMP]); and the railways (Canadian National Railway [CNR], Canadian Pacific Kansas City Limited [CP]). These companies command the majority of market share within their respective industries; effectively operating as dominant companies. For simplicity, we'll refer to the Canadian focused industries as the "Ferocious Four". Our work shows that these industries have delivered superior returns, compared to the TSX, over longer time periods.

The "Ferocious Four" and "Magnificent 7" account for about 31% and 28% of the S&P/TSX Composite and the S&P 500, respectively, as shown in the bottom right chart on the prior page.

Profitability

Next up, let's assess the profitability of these industries. Return on invested capital (ROIC) measures a company's effectiveness in generating after-tax dollars, adjusted by the amount of equity and debt used by the firm. We'll use ROIC as the basis in assessing profitability amongst the telecoms, grocers, and rails. Conversely, we'll reference return on equity (ROE) to measure the banks' profitability given they operate with significant leverage in an industry with strict capital requirements.

Starting with ROICs, telecoms, grocers, and rails have historically been more profitable than the S&P/TSX Composite across trailing 5-, 10-, and 20-year periods. However, the telecoms and grocers screen less attractive relative to the S&P 500 with rails as a notable exception.

With respect to the banks, 5-, 10-, and 20-year ROE profiles indicate that profitability is attractive relative to the S&P/TSX Composite but fall short when compared to the S&P 500.

Performance of the "Ferocious Four"

Turning towards performance, all four focus industries outperformed the S&P/TSX Composite and the S&P 500 on a trailing 20-year basis. Analyzing the 20-year CAGR, as shown in the below chart, returns were led by rails (+15.4%), followed by telecommunications (+10.9%), and the grocers and banks (+10.4%). For context, the S&P/TSX Composite and the S&P 500 generated CAGRs of +7.8% and +9.7%, respectively, during the same period.

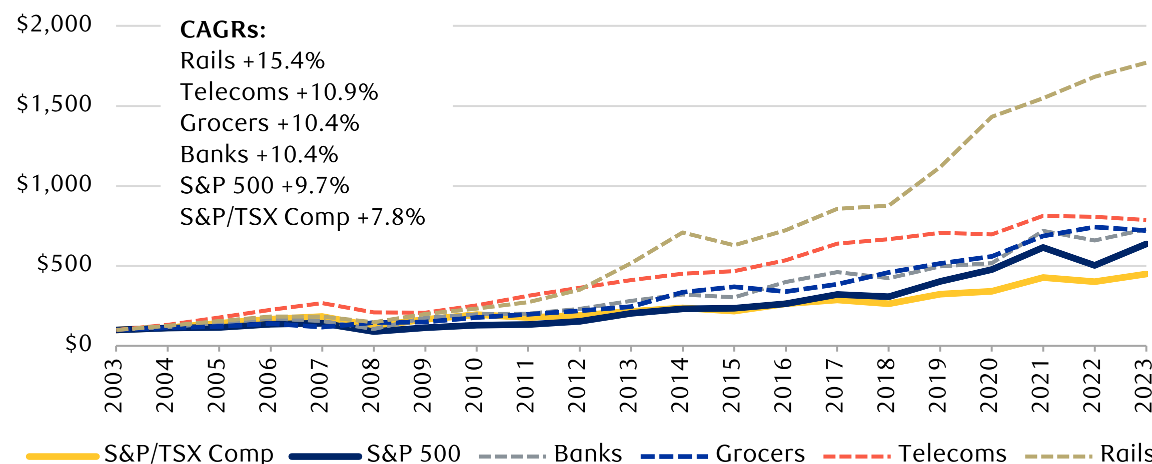
Average ROICs and ROEs

	Return on invested capital (ROIC)					Return on equity (ROE)		
Period	Telecoms	Grocers	Rails	S&P/TSX Comp	S&P 500	Banks	S&P/TSX Comp	S&P 500
5 years	5.2%	7.1%	12.3%	5.7%	9.5%	13.4%	10.6%	17.6%
10 years	6.5%	6.2%	13.7%	5.4%	8.9%	14.0%	9.7%	16.4%
20 years	7.3%	7.5%	11.9%	6.5%	8.7%	14.9%	10.8%	15.9%

Source - FactSet; data range 2003–2023

20-year CAGRs of Canadian focus industries

Total returns rebased to December 2003



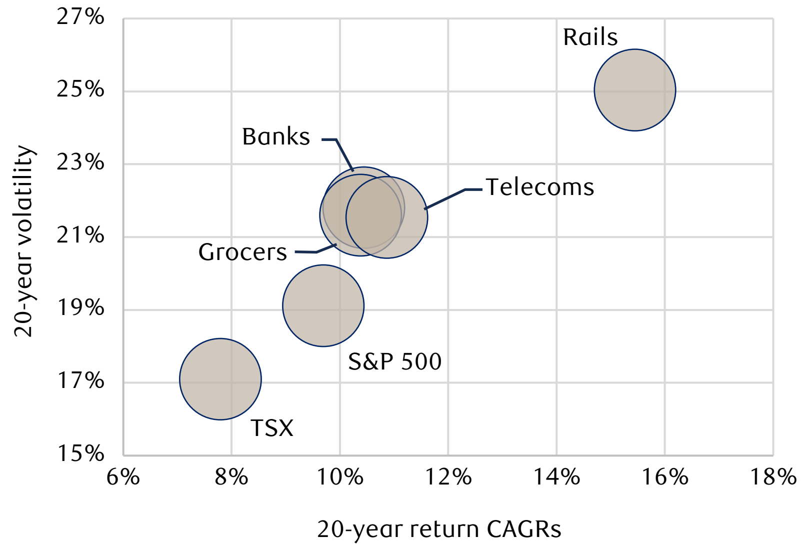
Source - FactSet

Volatility

While the "Ferocious Four" have delivered above-average market returns, they have also been more volatile compared to the S&P/TSX Composite and the S&P 500 over the past two decades. The grocers, telecoms, and banks have produced similar return and volatility profiles while rails have historically experienced the highest degree of volatility out of the group.

However, if we adjust the 20-year return CAGRs with their associated standard deviations, we can conclude that the "Ferocious Four" has produced more attractive, risk-adjusted returns relative to the S&P/TSX Composite. Conversely, rails is the only category that has generated more attractive returns per unit of risk compared to the S&P 500, as shown in the table at the middle of the page.

20-year returns compared to volatility



Source - FactSet; data range 2003–2023

Valuations

Overall, owning businesses with competitive advantages tends to be a sound investment decision but, valuations matter. In the chart below, we establish that the telecommunications industry is trading at the lower end of its five-year historical enterprise value to earnings before interest, taxes, depreciation & amortization (EV/EBITDA) range while the grocers are essentially trading in line with their five-year average. In the chart below, the rails industry screens expensive, trading at the upper end of its five-year historical price-to-earnings (P/E) range while the banks industry has also re-rated, slightly above its five-year historical average.

20-year risk-adjusted returns

	Risk-adjusted returns
Banks	0.48
Grocers	0.48
Telecoms	0.50
Rails	0.62
S&P/TSX Comp	0.46
S&P 500	0.51

Source - FactSet; data range 2003–2023

Relative valuations

Note: Data range 3/29/19–3/27/24. Telecoms and Grocers based on forward EV/EBITDA. Rails and Banks based on forward P/E.

Source - FactSet

Key takeaways

- The S&P 500 has historically outperformed the S&P/TSX Composite over long periods of time.
- Both the S&P 500 and S&P/TSX Composite come with a high degree of concentration risk. In the U.S., the "Magnificent 7" accounts for about 28% of the S&P 500 while the aggregate of grocers, telecoms, banks, and railways account for approximately 31% of the S&P/TSX Composite.
- The Canadian focus industries are more efficient in generating profits relative to the S&P/TSX Composite. Relative to the S&P 500, only the rails screen favourably from a profitability standpoint.
- With respect to historical performance, each industry we have discussed has produced attractive compound returns compared to the S&P 500 and the S&P/TSX Composite over the past 20 years. On a risk-adjusted basis, the "Ferocious Four" all screen favourably relative to the S&P/TSX Composite while only the rails have screened favourably compared to the S&P 500.
- From a valuation perspective, the telecoms screen cheap, grocers and banks appear to be within fair value territory, and the rails screen expensive compared to their five-year historical ranges.

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