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"Who is Afraid of the Canadian Stock Market?"

Addressed to The Empire Club of Canada on May 10, 2007

Kim Shannon
President & Chief Investment Officer

Canada geographically sits beside the world's biggest, deepest, most vibrant economic superpower on the planet today. Our economy ranks 14th based on GDP and 12th overall largest in the world. A long-time favourite pass-time of Canadians is to compare and contrast ourselves to our neighbours to the south and speak with pride about what we think is better here, but all too often the Canadian psyche looks for our shortcomings.

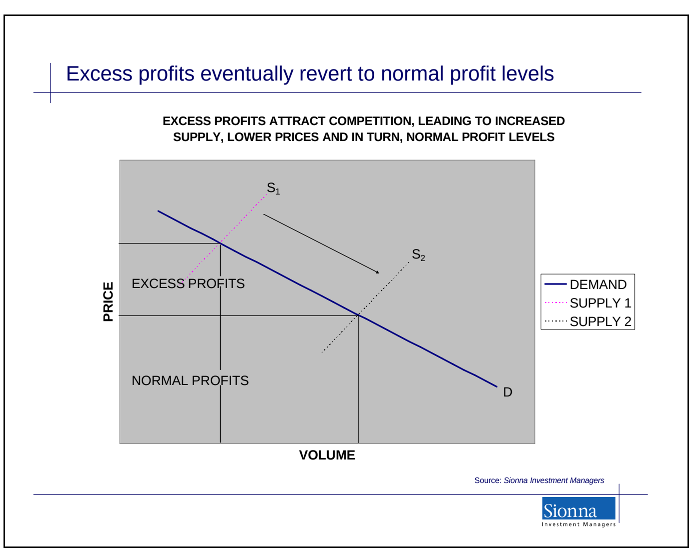
I have been employed in the Canadian capital markets since 1983 and over that time, the belief has flared and died down several times that the Canadian stock market is soon to disappear and join a North American stock market melting pot, that sometimes includes Mexico. Fortuitously, this has not yet occurred, and I do not believe it is likely to occur anytime in the foreseeable future.

Today I want to address a few of the negative and doomsday comments about the Canadian stock market by providing some context and possibly even refuting some of these comments.

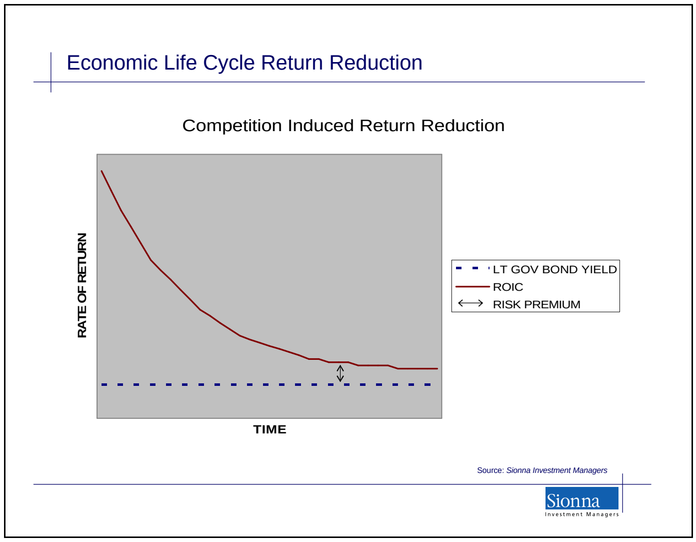
Argument #1: Canadian equities have outperformed global indices in the last few years. This is largely due to the run up in commodity prices. Therefore, it must be time to underweight Canadian stocks.

The implication of this argument is that Canada is likely to earn a lower return for investors in the next while. Thus, it is basically a timing suggestion with a short term perspective in mind.

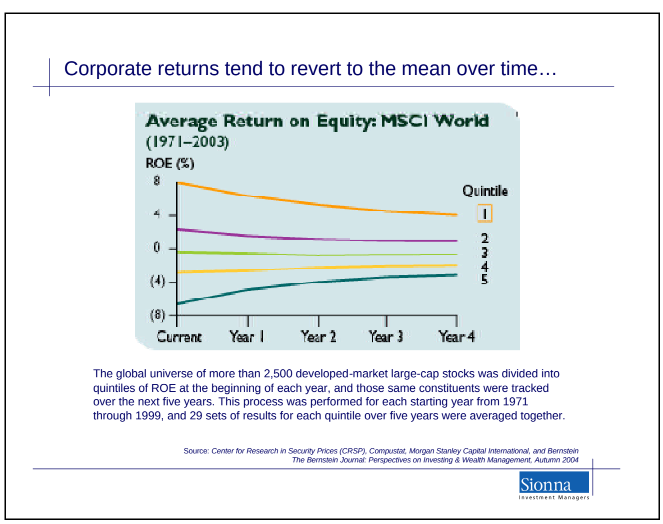
In Economics 101, we learned that excess profits attract competition, which creates more supply, which pushes out the supply curve until the price falls and a "normal profit" is earned again.



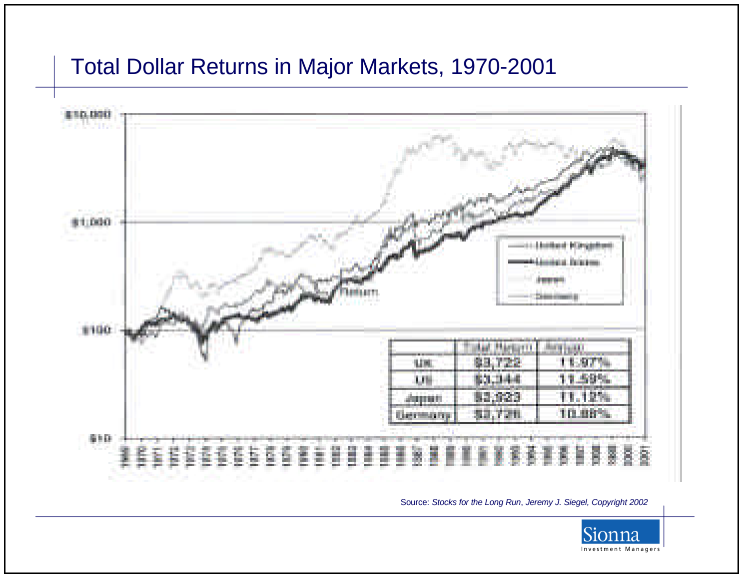
Conversely, sub-par profits will lead to players exiting the market place, which creates a decline in supply until prices and profitability rise back to a “normal profit” level. This relentless force pushing towards “normal profits” is true at a company level, an industry level and a country level. In the short run, anomalies (such as early stage growth, emerging industries, franchises, niche markets, competitive advantages) can occur, but in the long run, “normal profits” reign.

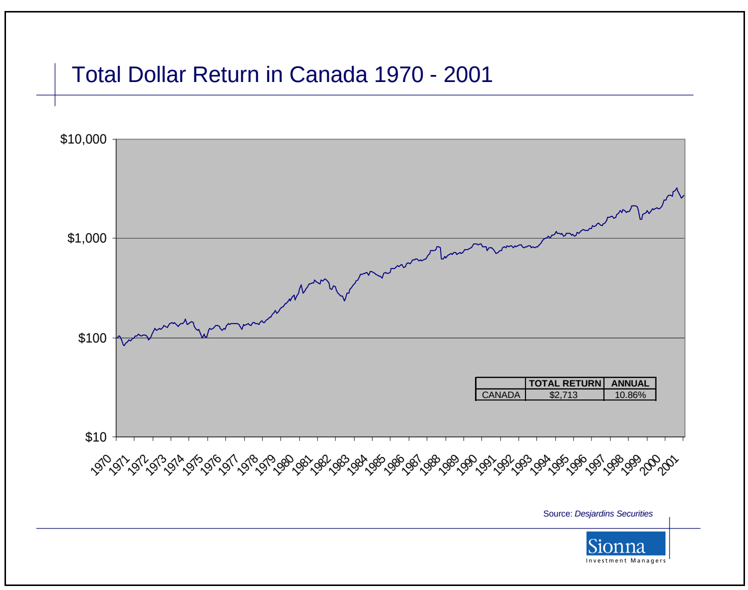


That’s the theory and numerous studies show that it also holds in the real world. A recent study by the Center for Research in Security Prices (CRSP) published in 2004 looked at a global universe of over 2,500 developed market large cap stocks. The stocks were divided into groups of similar level Return on Equity (ROE) and tracked over the following five years. This was repeated for each year starting from 1971 (when the MSCI Index was begun) through to 1999. The results showed that, over five years, the higher returning groups experienced an erosion of their profitability, while the worst returning groups saw their overall ROE rise over the 5 years.



So what is a normal return for stock markets? Over a thirty year time horizon (1970-2001), a selection of major markets including Canada, the U.S., the U.K., Japan and Germany, all had annualized total returns of 10.7% to 12.0% - a fairly tight range!





Also, a study on the earnings growth of 16 major countries over 100 years (1900-2000, FAJ 2003) showed that average annual earnings growth was 5.1% for all countries and 6.4% for non-war torn countries. Over that period, dividends would have been approximately 4.5% on average, which suggests that total returns, assuming that P/E multiples remained constant, would then be 9.6% on average for all countries and 10.9% for non-war torn countries.

Earnings Growth

Table 1. Earnings Growth: 16 Countries, 1900-2000

Country	Real Return
Australia	7.5
Belgium	2.5
Canada	6.4
Denmark	4.6
France	3.6
Germany	3.6
Ireland	4.8
Italy	2.7
Japan	4.2
Netherlands	5.8
South Africa	6.8
Spain	3.6
Sweden	7.6
Switzerland	5.0
United Kingdom	5.8
United States	6.7
Full-sample average	5.1
War-torn Group 1 average	4.0
Non-war-torn Group 2 average	6.4

Source: Financial Analyst Journal, William J. Bernstein and Robert D. Arnott, September/October 2003

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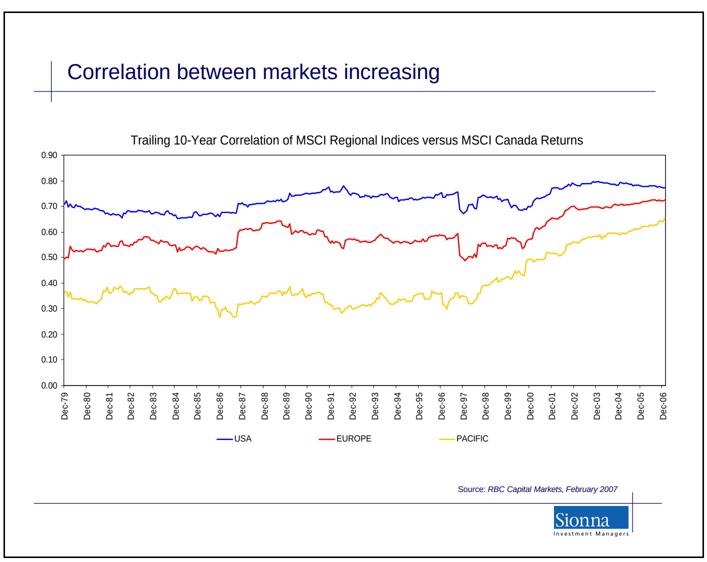
This centralization of long term returns over extended periods of time for most stock markets at 10%-12% is remarkable and is further collaborated by a noted trend - namely that with the advancement of globalization, market returns around the globe are converging, and the benefits to global diversification are diminishing.



Thus, it appears that a “normal” profit level for a mature stock market is approximately 10%-12% per year.

In the short term mature markets can have divergent returns…

In the long run mature market returns cluster in the 9-12% range.

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Most investors invest for the long run since the timing of markets or sectors is well known to be notoriously difficult to do consistently well. The argument that the Canadian market strength has probably run its course so now is the time to underweight Canada goes against most market wisdom that says to base your asset mix on asset liability matching at a pension level or risk reward trade-off pattern at an individual level and maintain your asset mix and diversification over time. So while I support the notion of taking away your excess profits, I believe this should only extend to the point that you take your weighting in Canadian equities back to their ideal asset mix level.

Argument #2: Canada’s top three sectors (industry groups) represent over 70% of our overall market capitalization. That is “too undiversified” and investors need greater levels of global exposure in compensation.

This argument implies that investors are fearful that they may earn less by investing in Canada, and that the Canadian market may be more risky and may have greater volatility than a global market basket.

But what is a “normal” sector spread for a market? The U.S. is considered to be a gold standard of depth and diversification, yet it has almost 53% of its market centered in three sectors (Financials, Info Tech and Consumer Staples). Germany’s top three sectors is 62%, U.K.’s top three is 58%, and Australia’s top three is 72%. Further, I have seen no evidence that a “balanced” weighting, if one existed, leads to better, less risky returns.

What is Normal for Sector Weights?

CANADA		FRANCE		GERMANY		JAPAN		ITALY		UK	
Financials	32.1	Financials	22.1	Financials	25.6	Cons staples	21.1	Utils	43.7	Financials	27.1
Energy	24.2	Cons staples	18.3	Cons staples	19.2	Financials	20.9	Energy	16.0	Cons staples	17.4
Materials	16.9	Utils	12.3	Industrials	16.9	Industrials	18.6	Industrials	13.1	Energy	13.7
Info tech	5.3	Energy	11.3	Utils	12.0	Info tech	12.0	Cons staples	10.5	Cons Discret	9.4
Industrials	4.7	Industrials	9.8	Materials	10.5	Materials	9.2	Financials	6.7	Materials	8.0
Cons staples	4.7	Health care	6.6	Health care	6.1	Health care	4.4	Health care	3.8	Health care	7.4
Cons Discret	4.7	Cons Discret	6.4	Telecom Svcs	4.6	Telecom Svcs	3.9	Materials	2.8	Telecom Svcs	6.1
Telecom Svcs	4.6	Info tech	5.1	Cons Discret	2.3	Utils	3.8	Info tech	1.9	Utils	4.6
Utils	1.4	Materials	4.5	Info tech	2.0	Cons Discret	3.6	Cons Discret	1.4	Industrials	3.1
Health care	1.3	Telecom Svcs	3.6	Energy	0.9	Energy	2.6	Telecom Svcs	0.0	Info tech	3.1
TOP 2 SECTORS	56.3	TOP 2 SECTORS	40.4	TOP 2 SECTORS	44.8	TOP 2 SECTORS	42.1	TOP 2 SECTORS	59.7	TOP 2 SECTORS	44.5
TOP 3 SECTORS	**73.2**	**TOP 3 SECTORS**	**52.7**	**TOP 3 SECTORS**	**61.7**	**TOP 3 SECTORS**	**60.7**	**TOP 3 SECTORS**	**72.8**	**TOP 3 SECTORS**	**58.2**

US		BRAZIL		CHINA		INDIA		RUSSIA		AUSTRALIA	
Financials	22.8	Materials	23.2	Financials	34.9	Energy	21.3	Energy	60.6	Financials	41.7
Info tech	15.8	Financials	19.7	Energy	19.7	Info tech	14.3	Materials	11.5	Materials	20.0
Cons staples	13.9	Energy	16.1	Cons staples	12.3	Materials	12.2	Financials	9.3	Industrials	9.8
Health care	11.2	Cons staples	12.8	Materials	11.5	Financials	11.7	Utils	8.3	Con Disc	6.6
Energy	9.3	Utils	11.1	Industrials	6.3	Industrials	11.6	Telecom Svcs	6.7	Cons staples	6.4
Industrials	9.1	Industrials	9.3	Info tech	3.8	Cons staples	8.6	Cons staples	2.3	Energy	6.0
Cons Discret	7.7	Telecom Svcs	5.7	Utils	3.3	Telecom Svcs	7.1	Industrials	1.0	Telecom	3.3
Materials	3.9	Cons Discret	1.3	Health care	3.1	Utils	6.5	Info tech	0.3	Health Care	3.2
Utils	3.5	Info tech	0.5	Telecom Svcs	2.7	Health care	4.2	Health care	0.0	Utilities	1.9
Telecom Svcs	2.7	Health care	0.2	Cons Discret	2.2	Cons Discret	2.4	Cons Discret	0.0	Info tech	0.9
TOP 2 SECTORS	38.7	TOP 2 SECTORS	43.0	TOP 2 SECTORS	54.6	TOP 2 SECTORS	35.6	TOP 2 SECTORS	72.0	TOP 2 SECTORS	61.7
TOP 3 SECTORS	**52.5**	**TOP 3 SECTORS**	**59.0**	**TOP 3 SECTORS**	**67.0**	**TOP 3 SECTORS**	**47.8**	**TOP 3 SECTORS**	**81.4**	**TOP 3 SECTORS**	**71.6**

Source: *Merrill Lynch Canada, Bloomberg, February 2007*

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Ricardo’s famous Law of Comparative Advantage, which shows the benefits of trade, points out that if every country focussed on the products that they were most efficient in producing and exported them, while importing from other countries what they were inefficient in producing, then global wealth would rise and country wealth would rise and all would benefit. This justifies the idea that countries **should** have greater weights in sectors in which they have a cost and productivity advantage in – which is what appears to be the case for Canada in the Financials and Resource sectors.

The Law of Comparative Advantage

“…if each nation specializes in the production of goods in which it has a comparative cost advantage and then trades with other nations for the goods in which they specialize, there will be an overall gain in trade, and overall income should rise in each trading country.”

David Ricardo
1772-1823

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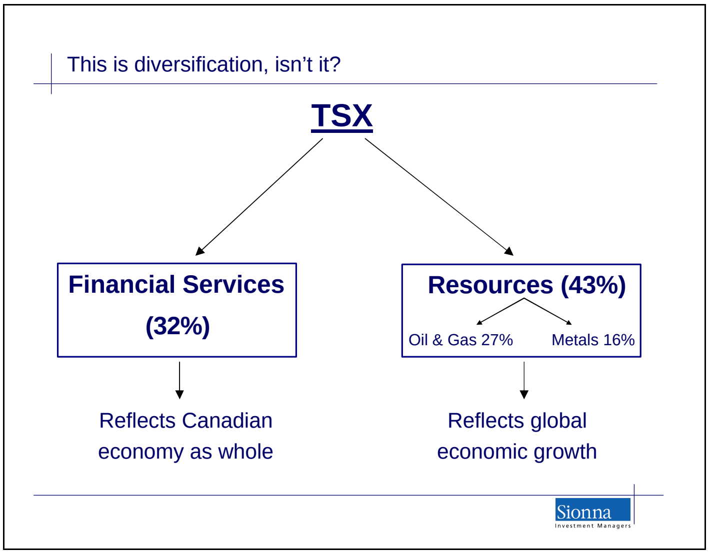
Financial Services most frequently shows up as one of the three largest sectors in most markets. In general, the Financial Services sector reflects the overall Canadian economy as consumers and businesses deposit assets and the bank lends out and supplies services to Canada. The resources reflected in the Energy and Materials sub-sectors are priced on the margin by global demand and thus reflect the strength or weakness of the overall global economy.



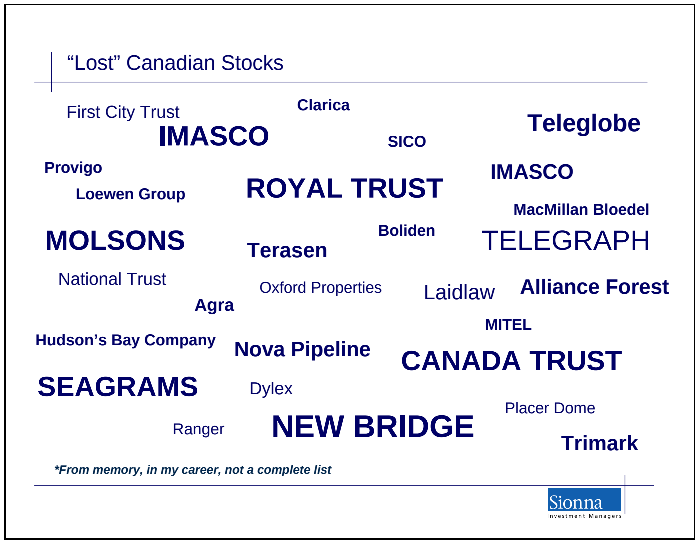
In this respect, the Canadian stock market's sector concentration in resources and financials can be viewed as positive from a diversification benefit as these two sectors are negatively correlated.

Thus the argument to underweight the Canadian market and redeploy to global markets will likely expose investors to currency risk, while essentially providing a similar return in the long run. With a fiscally prudent government, low government debt, low corporate debt, low consumer debt, low and targeted inflation and possibly still a cheap currency, this may not be the best time to take on excess currency risk as a Canadian.

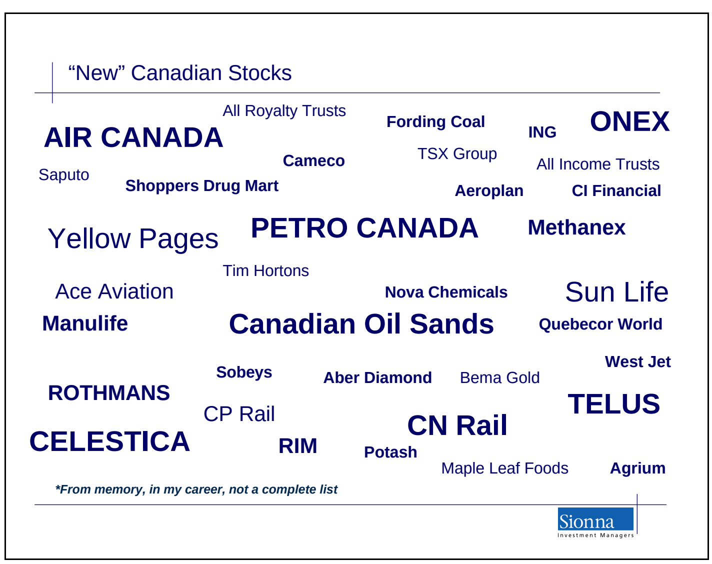
Argument #3: Global buyouts, mergers and consolidations are removing so many Canadian large cap stocks that we will soon no longer have a viable, stand alone stock market.

All markets experience a natural evolution of new companies emerging and growing in weight by acquiring others, while other companies are declining, getting taken over, or going under. From 2003 through 2006, foreigners spent $210 billion on acquisitions of Canadian controlled assets, but Canadian firms did $225 billion of deals for foreign assets, according to Crosbie and Co. That figure will only be aided by Thomson Corp.'s recent bid for Reuters.

Throughout my entire career dating back to the early 1980s, I have heard the forecast that the Canadian market will shortly disappear and we will soon become a North American market. The markets are subject to fads and fashions. If I had known with certainty that all the trusts, Imasco, Seagrams, Labatt, Molson, Dylex, Laidlaw, Nova, Placer Dome, Telegraph, Dofasco, Noranda, and Falconbridge would be gone from the market over the next 25 years, I too would have believed that the Canadian market would have truly disappeared.



But evolution creates new names as well. Most of the life insurance industry de-mutualized seven years ago, and SunLife and Manulife entered the capital markets. The government privatized companies such as Air Canada, Petro Canada, and CN Rail. Telus, Potash, TSX, Income Trusts and Royalty Trusts have emerged over the last decade, as well as RIM, Celestica, and Canadian Oil Sands Trust.



Despite the headlines, a recent article in the London Financial Times noted that net attrition to foreign takeovers in Canada has been 2%-3% of market capitalization since 2004.

Is the Canadian Market Shrinking? Probably Not!

- Net attrition to foreign takeovers has been 2-3% of market cap since 2004.
- Canada's market value was 4% of U.S. market cap in 1999 and is 10% today.
- In 1996, Canada had only one corporation in the world's top 200 by market cap. Today, it has seven.
- Since NAFTA in 1994, more foreign companies were purchased by Canadian companies than Canadian companies were purchased by foreigners. (Crosbie & RBC Economies)

Source : Data from BMO Capital Markets, October 2006

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Furthermore, Canada's market capitalization versus the S&P market capitalization in 1999 was less than 4% and today is 10%, and although our currency has done better, it doesn't entirely explain this rise.

North American Stock Market Capitalization

Year End	TSX 60 C$ Bln	TSX Comp C$ Bln	S&P 500 C$ Bln	TSX 60 as a % of S&P 500	TSX Comp as a % of S&P 500
1989	129	180	2,741	4.7%	**6.6%**
1990	112	151	2,545	4.4%	**5.9%**
1991	127	174	3,262	3.9%	**5.3%**
1992	127	181	3,830	3.3%	**4.7%**
1993	168	262	4,383	3.8%	**6.0%**
1994	182	270	4,700	3.9%	**5.8%**
1995	214	319	6,254	3.4%	**5.1%**
1996	291	444	7,710	3.8%	**5.8%**
1997	354	531	10,797	3.3%	**4.9%**
1998	387	548	15,273	2.5%	**3.6%**
1999	535	742	17,789	3.0%	**4.2%**
2000	622	829	17,580	3.5%	**4.7%**
2001	533	713	16,698	3.2%	**4.3%**
2002	466	619	12,805	3.6%	**4.8%**
2003	581	781	13,291	4.4%	**5.9%**
2004	692	925	13,524	5.1%	**6.8%**
2005	866	1,175	13,133	6.6%	**8.9%**
2006	935	1,321	13,071	7.2%	**10.1%**
Annual Growth Rate					
Since Jan 1990	12%	12%	10%		
Since Jan 2000	8%	9%	-4%		

Source : BMO Capital Markets

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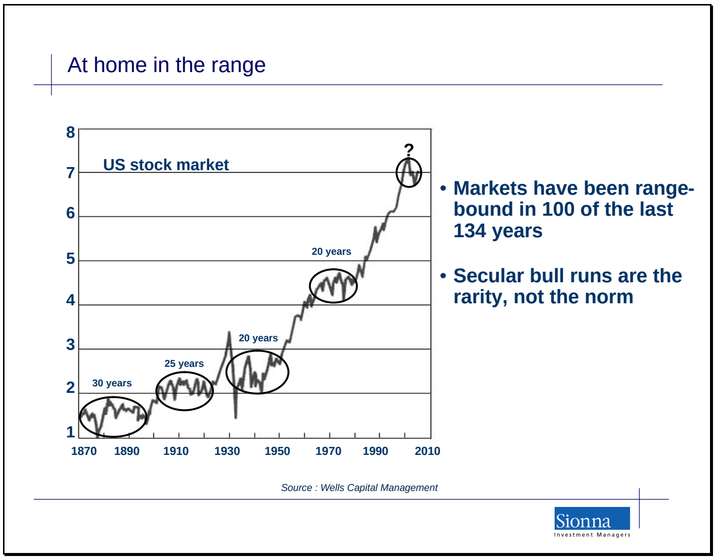
In 1996, Canada had only one corporation in the world’s top 200 companies by market cap and today we have seven. Fourteen Canadian stocks are included in Fortune’s list of the largest 500 companies (in comparison, Switzerland had twelve, Australia had eight). (DeCloet) Since NAFTA in 1994, more foreign companies were purchased by Canadian companies than Canadian companies were purchased by foreigners.

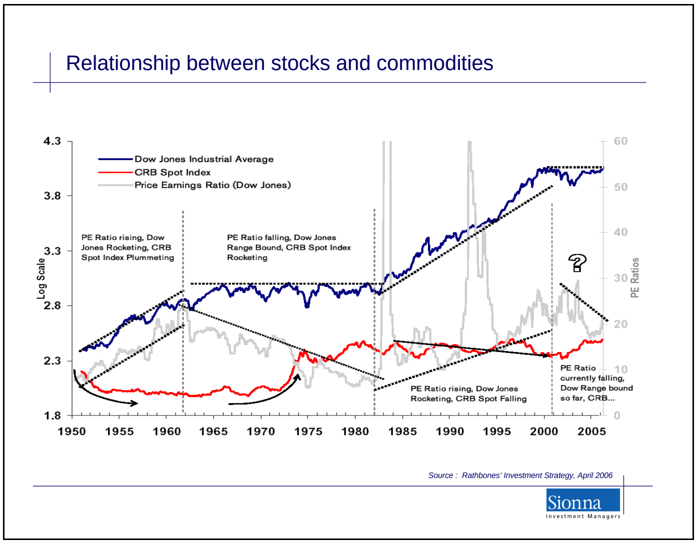
It appears that the Canadian capital market has grown-up, that we are no longer a branch plant economy and that we are active acquirers of foreign firms ourselves.

Argument #4: Resource stocks are cyclical stocks, commodity prices will soon collapse and thus one should underweight the resource exposed TSX.

Markets are more frequently range bound than they are in a bull market. After a period of enthusiasm for financial assets, where the prices of stocks rise and P/E multiples expand, the market then capitulates and consolidates and trades in a range bound area for 15 to 30 years. There will be strong rallies and frequent pull backs until all financial excess has been removed and P/E multiples correct. Since 1929, P/E multiples have corrected down to single digit multiples before the market can then muster new enthusiasm with novice investors to lead another bull run.



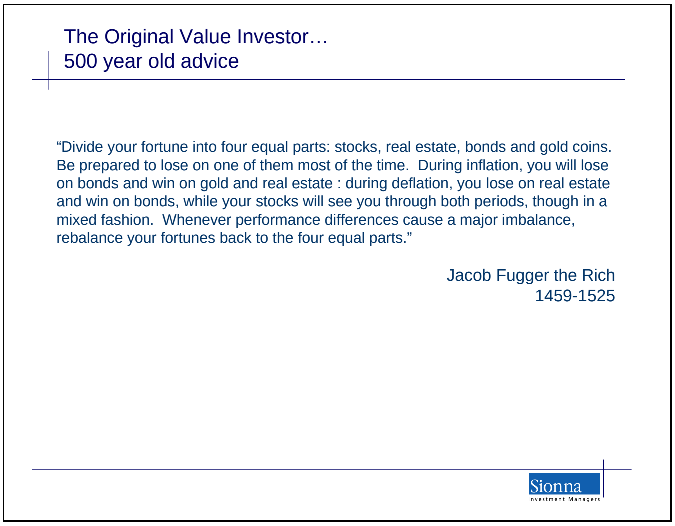
Financial assets, represented by the stock market, and hard (or fixed) assets tend to have valuations that move in opposite directions. When financial assets are rising in value, hard assets tend to fall and visa versa. Canada, one of the most resource heavy stock markets, has tended to outperform other major markets when hard assets values are rising, as is currently the case.



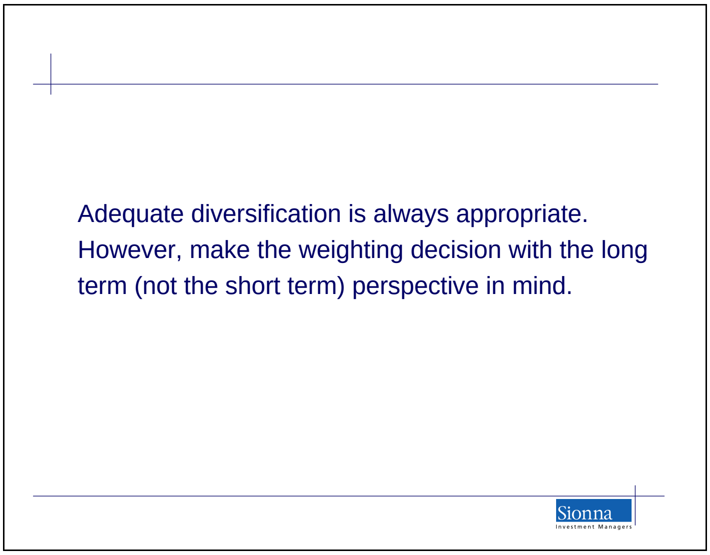
Since Canada is in the 7th year of what is usually a minimum 15 year sideways market, and also given that P/E multiples globally are above their historical averages, as a value manager I remain reasonably confident that hard assets likely have another 5 to 10 years of decent performance.

Further, although resources are notoriously cyclical (meaning they move with a 3 to 5 year economic cycle), they also respond to periodic supply shortages with longer term secular responses. Again, we are comfortable that the move in resources, particularly oil and gas, may well have a bit more time to play out. If this is true, this may be one of the “best of times” to be invested in the Canadian market and it would be a shame if Canadian investors were under-invested at this time.

After refuting less than ideal advice, like market timing, potentially excessive diversification, and excessive currency risk, I thought I would conclude by sharing with you an excellent piece of investment advice by Jacob Fugger the Rich. He lived 500 years ago, yet this simple and effective advice has stood the test of time.



“Divide your Fortune into four equal parts: stocks, bonds, real estate and gold coins. Be prepared to lose on one of them most of the time. Whenever performance differences cause a major imbalance, rebalance back to the four equal parts.”



Adequate diversification is always appropriate. Today the average Canadian pension fund has allocated 28% of their assets to non-domestic securities, which is the global median. My concern is that investors are being advised to go significantly higher than this level for timing reasons, or false perceptions of the relative risk or return of the Canadian market.

Pension Plan Foreign Content

Pension Funds - Foreign Content As a Percentage of Total Assets (2005)

Countries	Equities	Bonds	Total Foreign
Ireland	59%	12%	**71%**
Netherlands [1]	25%	21%	**46%**
U.K.	29%	1%	**30%**
Finland [1]	20%	8%	**28%**
Switzerland	18%	11%	**28%**
Sweden	15%	13%	**28%**
Canada [2]	22%	4%	**26%**
Belgium [1]	20%	4%	**24%**
France [1]	9%	10%	**19%**
U.S. [3]	14%	2%	**16%**
Portugal [1]	10%	4%	**14%**
Spain [1]	11%		**11%**
Germany [1]	5%	3%	**8%**
Median	**18%**	**6%**	**28%**

1: Foreign Content defined as outside eurozone countries.
2: Based on Q3-06 figures.
3: Based on the 200 Largest DB Plans
Source: Mercer, Pensions & Investments, Statistics Canada, Scotia Capital

Since most Canadian investors will live and die (to put it bluntly) in Canada, there is no need for them to be exposed to excessive currency risk, especially since Canada provides similar returns to any other major market in the long term.

Thus, Canada deserves an appropriate and significant position in your portfolio.

And let us be proud of the progress our capital markets have made. Foreigners might want to buy our stocks, but our stock market will continue to evolve and exist and serve us for the future years to come.

Thank you to Mel Mariampillai and Susan Ko for helping me prepare this speech.

Thank you so much for doing me the honour of addressing you today, I really appreciate it.

Good afternoon.