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Silver lining in the gradual erosion of TSX's "Big Three" sectors

Back in 1930, Canadian economist Harold Innis used the Biblical phrase "hewers of wood and drawers of water" to describe the Canadian economy's traditional economic dependence on resource production. That skewed impression of the Canadian economy lingers to this day, despite the services sector employing more than 80% of working Canadians, while less than 20% are employed in goods production.

Canada's traditional resource dependence is reflected in the composition of its benchmark TSX Composite index, which has historically been dominated by its big banks and resource giants. But the dominance of the TSX's Big Three sectors – Financials, Energy and Materials – is finally being challenged in a sustainable manner. While it may not be apparent at present, the steady erosion in the combined weight of the Big Three could be a significant benefit to Canadian investors in the longer term.

Presently, Financials make up 28.4% of the TSX Composite, with Materials accounting for 15.2% and Energy for 12.0% (Figure 1). The combined weight of these three sectors is currently 55.6%, which is a substantial reduction from the 65% to over 70% share of these sectors in recent years.

That decline can be attributed primarily to the freefall in energy stocks. The Energy sector's 34% plunge year-to-date has resulted in its share of the TSX falling to about one-half of its 20% weight a few years ago. The other reason: the drop in bank and insurance shares, with the Financials sector -19% YTD.

The Information Technology sector, now the 5th biggest on the TSX, has been the biggest beneficiary of the lowered weight of the Big Three in the TSX. The IT sector is by far the best performer on the TSX this year, with a 70% surge YTD. The sector now accounts for almost 11% of the TSX, effectively doubling its weight from a few years ago.

But one problem with those impressive numbers are that they are largely the result of Shopify's dominance of the Canadian Information Technology sub-index. Shopify has soared 174% this year, making it the largest Canadian company – with a market capitalization of $160 billion – and the biggest TSX constituent (Fig.2). Shopify also accounts for 62.5% of the 10-member TSX IT sub-index, which may bring back unhappy memories of similar dominance by Blackberry and Nortel in the last two decades (Nortel single-handedly made up 35% of the TSX at the stock's peak in the late 1990s).

But while those episodes ended badly, there are grounds for more optimism this time. While Shopify hogs the headlines, there are some solid Canadian technology companies that have posted stellar returns this year, such as Kinaxis, Constellation Software and Descartes Systems Group.

There are growing technology hubs in the biggest Canadian cities (and some smaller ones as well), which bodes well for the long-term success of this key sector. As we had noted in this publications a few weeks ago, the latest immigration restrictions south of the border could also benefit Canada in two ways – overseas technology workers may prefer Canada to the U.S. as an immigration destination, and the brain drain that sees thousands of Canadian technology professionals head to the U.S. each year may be stemmed or even reversed.

The Utilities sector, which currently makes up 5% of the TSX, is another one that could also steadily increase its weight in the TSX going forward. Canada has global leaders in renewable energy, and the above-average dividend yields of utility stocks is attractive in an era of "low for long" interest rates.

Our client portfolios have benefited from significant underweights to energy and financials, and some exposure to utilities and technology. Going forward, Canadian investors should benefit from the increasing diversification of the TSX, as the diminishing influence of cyclical sectors like financials and resources (combined with the growing weight of knowledge industries like technology, and steady cash-flow sectors like utilities) reduces volatility and generates more stable returns.

Figure 1: TSX Composite Sector Breakdown

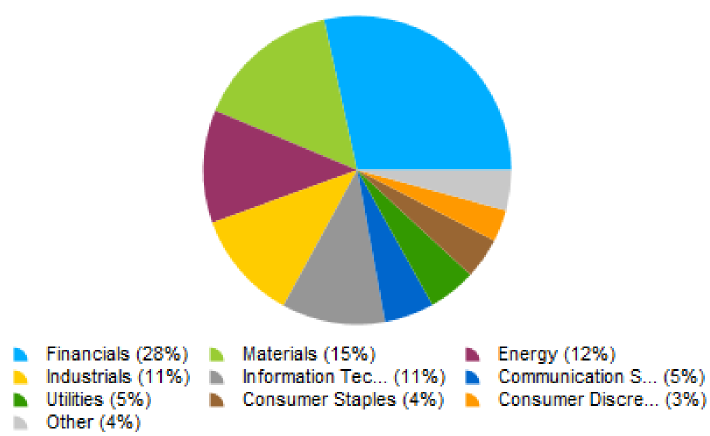

Figure 2: TSX Composite – Top Ten Constituents

Company Name	Symbol	% Weight
Shopify, Inc. Class A	SHOP-CA	6.73
Royal Bank of Canada	RY-CA	5.97
Toronto-Dominion Bank	TD-CA	4.96
Canadian National Railway Company	CNR-CA	3.93
Enbridge Inc.	ENB-CA	3.76
Barrick Gold Corporation	ABX-CA	3.04
Bank of Nova Scotia	BNS-CA	3.03
Brookfield Asset Management Inc. Class A	BAM.A-CA	2.84
TC Energy Corporation	TRP-CA	2.43
BCE Inc.	BCE-CA	2.28

Quote of the Week

"The only constant in life is change." – Heraclitus