INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

A winning portfolio

Analysis shows Canadian value stocks make a great foundation

November 2009 Print Edition

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Building a portfolio that beats the broad market indices over the long run is a daunting task for advisors. One asset class that forms the foundation of any such portfolio is Canadian value stocks, according to analysis by Toronto-based Tacita Capital Inc.

The MSCI Canada value index had an annualized compound rate of return of 12.4% from January 1975 through September 2009, outdistancing the S&P/TSX composite index's 11.1% return and far in excess of the 8.7% return of the MSCI Canada growth index. Over this almost 35-year period, the incremental wealth creation of value stocks was significant: 46% more than the S&P/TSX composite index.

Value stocks were also a touch less volatile, with an 18% standard deviation, in contrast to 18.5% for the S&P/TSX composite index.

Income-oriented portfolios, in particular, benefit from the inclusion of Canadian value stocks. The income component of the MSCI Canada value index had an annual return of 3.9%, far in excess of the 2.1% income return from the MSCI Canada growth index. The value index's income component was also very stable, with a standard deviation of only 0.4%.

Of course, Canadian value stocks do not outperform all of the time. That being said, value stocks beat growth stocks in 24 of the past 34 calendar years — a full 70% of the time. Value tends to outperform earlier in the business cycle as the economy moves out of recession, but frequently lags later in the cycle.

Value stocks can be out of favour for prolonged periods. Canadian growth stocks, for example, outperformed value stocks from 1997 through 1999. Unfortunately, many investors abandoned value stocks during the tech boom in frustration and missed the stunning 102% outperformance of growth stocks in 2000-01. Thus, investors need to be patient if they want to access the value stock's superior long-term returns.

There are sector biases in value and growth stocks. Since 1988, the MSCI Canada value index has had a 0.85 correlation with the S&P/TSX financials subindex, a decided contrast to the 0.44 correlation displayed by the MSCI Canada growth index. On the other hand, the MSCI Canada growth index had a 0.71 correlation with the S&P/TSX infotech subindex, much greater than the 0.38 correlation displayed by the MSCI Canada value index.

Correlations vary over time, however. With the recent commodities boom, the MSCI Canada growth index has been more correlated with the energy and materials subindices.

Unfortunately, unlike mutual funds in the U.S., Canadian funds are not classified as value, core or growth. Advisors will have to sort through more than 100 Canadian mutual funds of numerous asset classes to identify those that really focus on value stocks.

Although the majority of Canadian mutual funds have a value tilt, many blend growth and value. In a review of Canadian equity mutual funds that have been in existence for more than seven years, only a handful — including Beutel Goodman Canadian Equity Fund, from Toronto-based **Beutel Goodman & Co. Ltd.;** and Bissett Canadian Equity Fund, sponsored by **Franklin Templeton Investments Corp.** of Toronto — had correlations of 0.9 or greater with the MSCI Canada value index.

Advisors interested in purer exposure to value should consider two exchange-traded funds: iShares CDN Value Index Fund, from **Barclays Global Investors Canada Ltd.** of Toronto; and Clay-more Canadian Fundamental In-dex ETF, from Toronto-based **Clay-more Investments Inc.** These ETFs have had 0.98 and 0.97 correlation, respectively, with the MSCI Canada value index since their inception.

They have also performed well: in an analysis of more than 100 Canadian funds, Claymore Canadian Fundamental Index ETF and iShares CDN Value Index Fund ranked fifth and 12th, respectively, in return performance. **IE**

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