OPINION

Why the TSX is set to outperform U.S. stocks over the next 10 years

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In May, 2017, I was one of 30,000 investors who made the pilgrimage to Omaha, Neb., to listen to Warren Buffett at Berkshire Hathaway's annual meeting. As I sat in the uncomfortably hard plastic chairs, bracing myself for the multiple hours of Q&A, it was the very start of the meeting that would stay in my memory.

Mr. Buffett placed a spotlight on Jack Bogle, an investor whom he had consistently praised for his pioneering use of low-cost index funds. Although Mr. Buffett is history's most successful active investor, he had long preached passive investing through low-cost index funds as the proper method for the vast majority of investors.

As Mr. Bogle rose to thunderous applause, I couldn't help but see the irony that an arena full of active investors, myself included, were giving the most famous passive investor a standing ovation.

Mr. Buffett's praise for passive investing was of course excellent advice. A recent S&P Dow Jones publication confirmed the results of many previous papers on the subject. Owing to a combination of high fees and adverse security selection, the vast majority of fund managers underperform their benchmark over the long term.

According to the report, 52 per cent of funds in Canada underperformed their benchmark in 2022. This figure increased to 84 per cent over a three-year period and finally 93 per cent over the past five years. In the U.S., the study went back 20 years, and indeed even greater underperformance occurred, with 95 per cent of funds tracking the S&P 500 not meeting their benchmark.

Whether by skill or luck, this has fortunately not been our case. With a concentrated portfolio, we have compounded returns from 2012 to 2019 at 21 per cent per year versus 8 per cent for the TSX, and by 35 per cent per year since launching our partnership in 2020 versus 7 per cent for the TSX. We remain hopeful that we can continue to beat the odds, but I have always said to friends and family that weren't accredited investors that they should just go passive with low-cost index funds. But I would always be asked: "Should I buy a Canadian index fund, a U.S. one or both?"

For most of my career, I recommended they focus exclusively on the U.S. due to a relatively attractive valuation and higher sector diversification, but it seems increasingly likely that the bank and resource dominated TSX is poised to outperform the now tech-heavy S&P over the next 10 years.

In the past decade, the S&P has compounded at 13 per cent per year, easily beating the TSX at just 8 per cent. Ten years ago, the market valued the TSX at a higher multiple than the S&P (17 times trailing earnings for the TSX versus 15 times for the S&P), but now the TSX trades at 15 times trailing earnings while the S&P has jumped to 22.

If we focus on a less margin-sensitive measure such as price-to-book value, the difference is even more striking. Back in 2013, the S&P traded at 2.4 times price-to-book, a slight premium to the TSX at 1.8 times, but today the S&P trades at a whopping 4.2 times value, while the TSX remains at just 1.8 times.

Today's lower valuation for the TSX comes with potential macroeconomic upsides that lead me to believe the TSX actually has rosier prospects than our friends south of the border. First, with the recent interest-rate hikes increasing recession concerns, investors have now sold our financial stocks down to valuations that are pricing in economic stress not seen since peak pandemic lockdowns and the global financial crisis in 2008. Second, resource companies have had to endure a difficult period with the price of commodities negative over the past 10 years, particularly oil, which has lost more than a quarter of its value.

However, this dire situation looks unlikely to continue, as the underperformance has starved the industry of new development, with 2022 global commodity capital expenditures just half of 2013 levels. Oil consumption hit an all-time high in 2023, creating a favourable outlook for higher prices going forward. Mr. Buffett would seem to agree, as Berkshire has been accumulating billions in Occidental Petroleum stock over the past year. Finally, continued fears of global conflict and continuing supply-chain difficulties are causing a reshoring of commodity production to more reliable Western trade partners.

Whether taking an active management approach or passively investing through an index fund, investors may want to consider increasing their Canadian equity allocation relative to the U.S.

For our fund, we have the majority of our capital in Canada and TSX companies and, in fact, have zero net U.S. long exposure at the present time.

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