

Why Taking a Local Approach to Index Construction Matters in Canada

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While nearly everyone in the Canadian investment community has heard of the [S&P/TSX Composite](#), few are aware of the key methodological intricacies that distinguish it from other broad market Canadian equity benchmarks.

The most notable distinction is that the S&P/TSX Composite is designed specifically for Canadians (as are all S&P/TSX Indices), while many other Canadian equity indices, such as the FTSE Canada All Cap Index, are simply country slices of global benchmarks and, therefore, take the perspective of foreign investors. Why might this matter? Canada has foreign ownership limits that affect several industries, such as telecommunications, broadcasting, transportation, and real estate. Therefore, whether or not these limits are accounted for in the index is significant.

As an example, Bell Canada (BCE)—the largest Canadian telecommunications company—was the 10th largest company in the S&P/TSX Composite, with a weight of 2.3%, as of June 28, 2019 (see Exhibit 1). However, foreign investors are restricted from owning more than one-third of BCE under Canada’s Telecommunications Act. As a result, BCE’s weight in the FTSE Canada All Cap Index is reduced by two-thirds from its natural market-cap weighting to roughly 0.75%.

Exhibit 1: Top 10 Constituents

S&P/TSX COMPOSITE		FTSE CANADA ALL CAP INDEX	
CONSTITUENT	WEIGHT (%)	CONSTITUENT	WEIGHT (%)
Royal Bank of Canada	6.5	Royal Bank of Canada	7.0
Toronto-Dominion Bank	6.1	Toronto-Dominion Bank	6.6
Enbridge Inc	4.2	Enbridge Inc	4.4
Canadian National Railways	3.8	Canadian National Railways	4.1
Bank of Nova Scotia Halifax	3.8	Bank of Nova Scotia Halifax	4.0
Suncor Energy Inc	2.8	Suncor Energy Inc	3.0
Bank of Montreal	2.8	Bank of Montreal	2.9
TC Energy Corporation	2.6	TC Energy Corporation	2.8
Brookfield Asset Management	2.4	Brookfield Asset Management Inc	2.5
BCE Inc	2.3	Manulife Financial	2.2
Total	37.3	Total	39.3

Source: S&P Dow Jones Indices LLC; FTSE Russell. Data as of June 28, 2019. Table is provided for illustrative purposes.

Canada has foreign ownership limits that affect several industries.

Real estate investment trusts are also subject to a 49% ownership limit, which results in the weight of the Real Estate sector being reduced in the FTSE index relative to the S&P/TSX Composite. Ultimately, the differing treatments of foreign ownership limits is a key driver of the FTSE Canada All Cap Index's higher concentration in Financials and lower exposure to other sectors such as Communication Services and Real Estate, as illustrated in Exhibit 2.

Exhibit 2: Comparative Sector Weights (%)

SECTOR	S&P/TSX COMPOSITE	FTSE CANADA ALL CAP INDEX
Financials	32.0	34.2
Energy	17.1	18.0
Industrials	11.4	11.4
Materials	11.0	11.2
Communication Services	5.6	3.3
Information Technology	5.1	5.4
Utilities	4.3	3.5
Consumer Staples	3.9	4.2
Consumer Discretionary	4.2	4.2
Real Estate	3.4	2.7
Health Care	2.0	1.9

Differing definitions of what constitutes a Canadian company for index assignment purposes are also important to consider.

Source: S&P Dow Jones Indices LLC; FTSE Russell; Vanguard. Data as of June 28, 2019. In order to facilitate apples-to-apples comparison using GICS sectors, weights for the FTSE Canada All Cap Index are estimated using holdings of Vanguard FTSE All Cap Index ETF. Table is provided for illustrative purposes.

Differing definitions of what constitutes a Canadian company for index assignment purposes are also important to consider. For example, Shopify—the Canadian e-commerce company—was added to the S&P/TSX Composite in March 2017. However, FTSE Russell classified Shopify as a U.S. company until January 2019, which prevented it from being included in the FTSE Canada All Cap Index until earlier this year.

The S&P/TSX Composite is a broader representation of the Canadian equity market relative to the FTSE Canada All Cap Index.

The S&P/TSX Indices also include companies structured as limited partnerships (LPs), whereas FTSE Russell's global equity index methodology excludes them. Because of this, several Brookfield Partnerships that own and operate infrastructure, real estate, and renewable energy assets are excluded from the FTSE Canada All Cap Index. These companies represent a weight of about 1.5% in the S&P/TSX Composite.

Finally, the S&P/TSX Composite is a broader representation of the Canadian equity market relative to the FTSE Canada All Cap Index. As of June 28, 2019, the S&P/TSX Composite included 239 constituents, representing a total index market cap of nearly CAD 2.3 trillion, while the FTSE Canada All Cap Index included 205 components and a 6% smaller aggregate index market cap of CAD 2.15 trillion. This disparity is partially

driven by the inclusion of LPs, but it is largely due to the relatively more inclusive size and liquidity requirements of the S&P/TSX Composite.

Methodology differences have contributed to meaningful performance differences over time.

Exhibit 3: Index Characteristics		
CHARACTERISTIC	S&P/TSX COMPOSITE	FTSE CANADA ALL CAP INDEX
Number of Constituents	239	205
Float-Adjusted Market Cap (CAD Billions)	2,292.34	2,152.52
Largest	149.44	150.20
Smallest	0.56	0.30
Average	9.59	10.50
Median	3.00	3.37

Source: S&P Dow Jones Indices LLC; FTSE Russell. Data as of June 28, 2019. Table is provided for illustrative purposes.

While the returns of the two indices have historically tracked fairly closely, the methodology differences discussed have contributed to meaningful performance differences over time. As depicted in Exhibit 4, the 3.87% total return of the S&P/TSX Composite was nearly 1% greater than the FTSE Canada All Cap Index over the trailing 12-month period. Over the past 10 years, the S&P/TSX Composite has outperformed by 42 bps per year with slightly lower volatility.

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Exhibit 4: Risk/Return Comparison		
PERIOD	S&P/TSX COMPOSITE	FTSE CANADA ALL CAP INDEX
ANNUALIZED RETURNS (%)		
1-Year	3.87	2.97
3-Year	8.39	8.11
5-Year	4.67	4.29
10-Year	7.79	7.37
STANDARD DEVIATION (%)		
1-Year	14.20	14.18
3-Year	9.15	9.24
5-Year	9.04	9.22
10-Year	9.88	10.13
RISK-ADJUSTED RETURN		
1-Year	0.27	0.21
3-Year	0.92	0.88
5-Year	0.52	0.47
10-Year	0.79	0.73

Source: S&P Dow Jones Indices LLC; FTSE Russell. Data as of June 28, 2019. Calculations are based on gross total return index levels in CAD. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

CONCLUSION

In summary, it is important to look under the hood and understand the design features of seemingly similar benchmarks. Because of its

comprehensive nature and Canadian-centric design features, the S&P/TSX Composite may more fully and accurately reflect the investment opportunity set available to Canadian investors in comparison to other market indices.

As a final note, you may often see the [S&P/TSX Capped Composite](#) cited, given that it underlies several index-based products, and wonder how it differs from the headline S&P/TSX Composite. The term “capped” refers to the fact that the methodology includes a 10% cap—or limit—on the weight of any single stock. The capped version of the index was introduced back in 2000, when Nortel Networks grew to become so large that it represented nearly one-third of the weight of the S&P/TSX Composite. However, Nortel soon shrank and the S&P/TSX Composite and S&P/TSX Capped Composite have been nearly identical since 2001, as no company has held a weight in excess of 10%.

The S&P/TSX Composite may more fully and accurately reflect the opportunity set available to Canadian investors than other market indices.

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