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EP 163 | Navigating the Canadian Equity Landscape: Dispersion, Energy Transition, and Opportunities

[00:00:00] Andrew Johnson: Hi everyone. Andrew here. In this episode, I sat down with Mark Rutherford, co-manager of our Canadian large-cap equity strategy. We cover a lot of ground in a short amount of time. We start with the wide dispersion that we've seen across stocks and Canadian markets over the past year. From there, we step back a bit and dive into the long-term theme of the global energy transition and its far-reaching effects on almost all market sectors. Finally, we check in on how central bank efforts to tame inflation are impacting banks and life insurance companies here in Canada. Enjoy.

[00:00:35] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:00:52] Andrew Johnson: Welcome back to the podcast, Mark.

[00:00:54] Mark Rutherford: Thanks, Andrew. It's great to chat again.

[00:00:56] Andrew Johnson: I think the last time that you and I sat down on the podcast was back in the fall of 2023. I thought we would start there. I'd just like to hear your general thoughts on the investment landscape over the last six to 12 months. In particular, I think many people are curious as to the job central banks have had in trying to thread that needle of lowering inflation without causing too much harm to the economy. How is this reflected in the overall economy and among Canadian companies?

[00:01:21] Mark Rutherford: I think it's a good place to start with quite a bit of volatility in the news every day. Just the headlines can be quite dramatic at times, whether it's geopolitical risk or economic changes that are going on with higher rates. When you zoom out and you look at the longer term, we're actually seeing very healthy returns across equity markets in Canada, as well as internationally. and probably the most notable on the high end would be within the U.S.

When we zoom in a little bit more into Canada, what we really find is while the absolute level of returns is rather healthy and attractive, there is quite a bit of dispersion, and things are moving in different directions under the surface. For example, this year alone, if you look at the top-performing sectors that have actually been the top-performing sectors in the last few years, energy and materials would be near the top. Those are earning year to date looking at mid-teens type returns. On the other side of the equation, you have telecoms and real estate and some utility stocks that are really lagging the market and are down low single digits and even double digits. So quite a bit of dispersion across the landscape.

When we think about it and then we ask ourselves, really, what's driving that? And one, I think pointed it out, and that's that the high interest rates are really just having the intended effect on the economy that they should. They are slowing things down, but they are not hitting every area of the economy the same. So if you look at energy companies, a lot of them have already paid down a lot of debt, and their balance sheets are in pretty good shape. High interest rates may even be preventing some new projects from being invested in by energy companies. We're not seeing tremendous amounts of growth capex there.

So that's causing relatively high commodity prices. Energy companies are very happy to be producing that $80 oil, and the stocks well reflected that because they can buy back stock and return lots of capital to shareholders. On the other side of the equation – on the consumer side – we're seeing a lot more noticeable slowdown in terms of demand trends. A lot of companies out there reporting results recently, and a few – maybe ones that most people might know, Lululemon, Nike, McDonald's – some of the auto sales numbers have not come in particularly strong. Those are things that are more driven by consumers really tightening up or feeling a little bit more of the impact of higher rates.

Another similar area would be real estate where a lot of these companies rely on debt to finance buildings that they're going to develop or acquire. As those debt maturities are rolling over and they're refinancing them at higher rates, they're paying more and that's eating into some of the earnings growth that they have. So that's been another area of headwind.

One last area that I'd comment on within Canada that's particularly stood out that's historically been quite defensive and had some growth with it is the telecoms. We just continue to see a lot of the pricing challenges for the telecos where it's become more competitive in the market. We've talked about this, I think Andrew, on prior podcasts. That's an area where we've really de-emphasized. There are continued headwinds and competitive market intensity, as players are looking to grab market share. So that's a little bit more unique within Canada.

[00:04:34] Andrew Johnson: So certainly some dispersion in the market, given the circumstances, and obviously central banks and monetary policy have certainly been a major factor for these last several years. But if we step back, there are other underlying themes out there that are playing out over much longer time horizons. One of those longer-term trends or themes playing out around the world is, to use a very broad term, the energy transition. That's certainly relevant for us here in Canada as a producer of both traditional and renewable energy sources. But this really touches many other sectors and presents challenges and opportunities for investors. How do you assess the impact of that transition on Canadian equities over the longer term?

[00:05:12] Mark Rutherford: Yeah, it's something that I think is really important to highlight. It's a theme that we've talked about a lot internally, and it's certainly been there in the press as a topic of not only government policy but how companies are reacting.

I think from our perspective, one, we really take a bottom-up approach when we're looking to assess the impact of that longer-term trend. One thing we're really looking for is: Within each company, who's actually creating and driving the wealth creation while this transition is happening? The question we're asking is, "Where is there a need for capital in the economy because of this transition?"

From a regulatory perspective or a policy perspective, Vijay (Viswanathan) likes to say, "Are we on the right or the wrong side of city hall?" We don't want to be in too many areas where we think government could really be coming up with a policy that would negatively impact a particular business or business model. Lastly, at the company level, we're looking at capital allocation decisions; are they going toward energy transition projects that are very high return on capital and within the core competency, or are they really outside the core competency and very low return on capital? Those are some of the key questions and that's from a bottom-up level.

From a top-down level, if we think about Canada as a whole, we're fairly well positioned from an energy production standpoint. If you look at the power grids, Ontario, Quebec, and BC largely have a lot of hydro and nuclear power driving most of the energy grid. Even in Alberta, there's been a huge shift away from coal-powered; those plants have been transitioned to natural-gas-powered power plants. So there's been a huge reduction even within Alberta of the amount of emissions coming from power plants over the last 20 years. It's actually been much ahead of schedule within Alberta. So the country as a whole has really worked and transitioned large components of the energy grid.

From a natural resources perspective, that's another big opportunity longer term for Canada. If you look at the critical minerals landscape, there are lots of resources and reserves within Eastern Canada, as well as British Columbia and up north. That could be a very good long-term strategic asset for the country to develop and responsibly produce. I think the one other element that we need to really evaluate closely that I'd highlight is different from the U.S. is the IRA in the U.S. – the Inflation Reduction Act. So far, Canada doesn't really have a regulatory incentive framework that is on par with that. A lot of competing nations around the world are thinking about, “Okay, how can we develop a system that isn't going to cost an enormous amount that's going to really strain fiscal budgets and isn't going to result in all of our companies and intellectual capital going to the U.S. to be invested there?”

In Canada so far, there's more carbon tax framework, whereas in the U.S., it's really more tax incentives and outright cash payments to companies making certain investments. It's much more of a “care” approach in the U.S. That's one thing that we're closely watching as it evolves. Hopefully that's a little bit of an overview. I'm happy to get into some of the company-specific ideas, as well.

[00:08:18] Andrew Johnson: Yeah, that'd be great actually. That was going to be one of my follow-up questions. What are some of the sectors or business models that you and the team are spending the time discussing within this realm?

[00:08:29] Mark Rutherford: I'll start with just an obvious one that is somewhat counterintuitive just because of the industry reaction and that's the energy landscape. One thing that we've seen – and see continued forecasts that are updated annually on this – is really the demand for oil longer term. And that's been a big question of why own an oil and gas company if a lot of these technologies, like electric vehicles, are going to displace demand for gasoline longer term.

The other side of that is that there are emerging markets that continue to grow, and as people become wealthier on a per capita basis, they do tend to consume more energy. There's also the industry reaction that you have to factor in and what we're seeing, especially within Canada but also elsewhere, is we're not seeing very high levels of capex to go into new projects. That reaction to some of the threats out there longer term has actually created a very positive environment. It's oddly been a very good time to be invested in the energy landscape and that could continue for a long time to come.

Utilities would be another one there where it gets a lot of attention, and we have some exposure within the Canadian equity strategy. There are a couple of things that I'd highlight. One, they're investing to bring on a new production. That might be new renewables or new gas-fired power plants that need to be built to sustain the power demands that are coming from all sorts of avenues. More recently, AI has been a big potential driver or incremental change to that longer term. Within the Canadian equity strategy, we see companies like Fortis, Hydro One, AltaGas; they're all investing more and more every year and building the rate base up, which ultimately will grow earnings for them over time.

One that maybe is less evident is Brookfield. They have a very large renewables platform across the U.S. and Europe. They were very well positioned before the Inflation Reduction Act was passed. And that platform they have – if you think about what happened with the Inflation Reduction Act, it created added incentives to go do a lot of these renewable projects in an effort to accelerate that investment and that transition to cleaner fuels.

The analogy would be you're building a house, and all of a sudden, the government says, “Every new home that's built, we're going to give the developer $100,000.” Well, that immediately gets priced into the market. For new homes that maybe someone's looking to buy, the home price is going to reflect that new incentive that's in the market. But for all of the incumbent competitors that have built and established large renewable platforms like Brookfield, they immediately get that uplift in value because all of their projects, all of a sudden, are now getting this incremental benefit that they maybe didn't underwrite in the first place. So that would be one area that I'd highlight within the Canadian equity strategy.

Another big one that we've talked about internally and assessed and talked to companies about is climate change and the impact that is having. One company in particular that we think could potentially benefit from this longer term is Intact. What's happening with larger weather events that are more frequent and cost more over time is that's driving the need for insurance and growing the risk pool over time. That can ultimately lead to premium growth.

On the other side of that, it can create a risk, but we think companies like Intact have historically done a very good job in terms of pricing that risk. They can incrementally adjust as more data comes out and really reprice that book on an annual basis as they see the risks change in the market. The other tool that they have that's really nice longer term is a reinsurance option. They can cap limits to certain events, whether it's geographic areas or types of events that are happening, so they're not overly exposed.

Another one that's somewhat utility-related and also somewhat climate-change-related within the Canadian Equity Strategy would be Stella Jones. A big part of their business comes from utility poles, and utilities have been investing more aggressively in recent years to drive down some of the age of the poles within their network. So that helps the overall strength of the poles. They're newer and maybe less brittle. They're also doing things like purchasing more fire-wrapped and weather-resistant poles that Stella Jones is producing. So that's a nice benefit and tailwind for a company like Stella Jones in the portfolio.

Lastly, related to the mining and the critical minerals that we have within Canada and elsewhere in the world, I'd highlight Finning and Toromont within the Canadian equity strategy. Both Caterpillar dealers and both stand to benefit tremendously longer term, as they sell more to the mining companies, but then also attach higher margin product support and services to service those vehicles once they're out in the field and are out in the mine working.

So those would be a few areas that I highlight within this energy transition that we think provide longer-term tailwinds. It may not be the core thesis that drives every single investment, but it's certainly a tailwind and a factor that we're closely assessing.

So, Andrew, when we think about what's in the Canadian equity strategy for some of the dispersion and differences we're seeing, I think one that creates opportunities. So when we go back to our process internally here, it's having inventory lists of stocks that we don't own that we would love to own, maybe at the right price or something changed fundamentally about the business. On the other side of that, this high level of dispersion can present a lot of risks. If you have a big bet within one particular sector or area of the market or type of business model and that call is really wrong for a period of time, that also presents risks.

We're constantly asking ourselves, “Do we have sharp edges in the portfolio? Are there ways to mitigate or better position the portfolio in the current environment?” One simple heuristic that we use when we're going through the portfolio and looking at the construction of it – the different types of companies within it – is we just ask ourselves a simple question of “Where do we have headwinds, and which companies have tailwind?” When we think about some of the headwinds, which we can get to later a little bit, as real estate, those companies, whether it's some lawyers or even Brookfield asset management, somewhat on the fundraising side, more recently have had some headwinds.

Banks would be another area that we can touch on in more detail where they've faced some headwinds. As a result, we've actually pared those positions back a little bit and tried to reflect some of that in the portfolio weighting and how large of exposure we want to those businesses at this point in time. On the other side of that, there are companies that still are doing very well. So technology companies; some of those companies are not highly affected by higher interest rates because they have little or no debt. So companies like Constellation Software and Topicus continue to go and execute their business model and continue to roll up attractive software businesses at good prices and grow that way over time.

Loblaw would be another one where they've really benefited in this current environment where you've had some food inflation and broader inflation. So consumers are really shifting to discount banners. They have a superstore. They have a very large discount market share. Our assessment is gaining market share, and that's helped Shoppers Drug Mart; that business is also performing very well.

The last one would be energy companies and Canadian natural resources in particular. Even Suncor has performed well of late, where, as I mentioned, these companies have paid down a lot of the debt. So now they can really accelerate that cashflow return to shareholders through dividends and buybacks. That's just a simple heuristic where we think about just headwinds and tailwinds, and then the inventory list being another key part of the process to build that portfolio and factor in some of these macroeconomic forces into the portfolio level weightings.

[00:17:03] Andrew Johnson: I really appreciate that response, Mark. It's some great context to a very broad and, as you just highlighted, far-reaching topic within not just the Canadian space but globally speaking, as well. Before I let you go, I wanted to come back to some of your earlier comments and build on some of what you just touched on at least in terms of insurance companies.

I'm curious how the holdings within the insurance and the banking space are doing. Both of those business models are, one, prevalent in the portfolio, and they're both impacted by the uncertainty around interest rates, as well as whatever degree of probability we have around a potential slowdown for the consumer or economy. What's been happening with those stocks lately?

[00:17:43] Mark Rutherford: It's been quite the time for banks and insurance companies recently, with the level of changes going on from a regulatory perspective and looking across the economy, as well. I'll start with banks. You can think of banks in simple terms as a business model that's fairly exposed to economic growth and economic contractions. Because we're seeing a slowdown in growth, the banks are feeling that as well. They see that in terms of loan demand slowing. They continue to really move provisions higher for loan losses so that reduces their level of earnings. They're also dealing with costs and inflation across their core businesses, whether that's services they purchase, software or hardware, but also on the labour front in a tight labour market.

So they've had to deal with that. Then a capital markets business that they have as well. While equity markets have been rather strong, it has been a slower environment for things like M&A and IPOs in the market. So that's an area of the bank where they've felt a little bit more pressure. Lastly, because we're now getting reasonable returns on cash deposits, a lot of consumers and businesses are looking to deploy those and move them outside of maybe a bank and into some type of money market fund or strategy where they earn a higher return or even a fixed income strategy. So that creates some funding pressure and margin pressure on the banks.

If I switch to life insurance companies (lifecos), they don't have the same level of deposit movement that a bank would have. So if you purchase a life insurance policy, maybe you bought that policy up front, and you're paying some fixed amount every year in premium. Alternatively, if you bought an annuity, you pay some amount up front, and you get some guaranteed return or a variable return over the life of that annuity. That doesn't have the same redemption and liquidity risk that you might have in a deposit at a bank. So that has been more beneficial to them, as you can think of lifecos as really a large fixed income portfolio. They've benefited from that and higher interest rates, and their ability increases to reinvest their cash flows at higher interest rates. They don't have the capital markets businesses that the banks have.

There are also very big wealth management franchises within both companies in the Canadian equity strategy. Manulife is a very large wealth management franchise that spans Canada and internationally. IAG also has a wealth management strategy that's grown over time. So that combination of business mix has really helped. One thing I'd highlight in particular with Manulife, it's been one of the strongest performing financials across banks and life insurance companies now for the last five years, with a lot of that strength really coming in the last year, benefiting from finally getting rid of some of these variable annuity, long-term care policies that were written a long time ago in these legacy contracts.

As they've matured, there's more data on them, and they're producing a little bit more reliable stream of predictability for whoever owns them. That, combined with higher rates, has allowed them to reinsure those and sell some of those. As those legacy contracts have become a lower proportion of Manulife's earnings, you're seeing a better earnings mix and a higher ROE earnings mix. So that's a business that's actually performed relatively well of late that's also within the Canadian equity strategy. I think I'd highlight that as one example where it's just a different dynamic going on than the banks.

[00:21:10] Andrew Johnson: I know that in past conversations with you and Vijay, that's certainly been a topic with Manulife and how they can improve their earnings mix going forward, so it's nice to hear an update on that. I think it's a great place to wrap things up too, Mark. I'm sure between now and the next time we chat, we'll have more news on all of these topics that we talked about, and we talked about a pretty wide range of them, and likely some different themes emerging as well.

Thanks for spending some time today, and I’m looking forward to the next time we get to catch up.

[00:21:34] Mark Rutherford: Happy to. Thanks, Andrew.

[00:21:36] Andrew Johnson: Hey everyone, Andrew here again. To subscribe to the Art of Boring Podcast, go to mawer.com. That's M A W E R dot com forward slash podcast or wherever you download your podcasts. If you enjoyed this episode, leave a review on iTunes, which will help more people discover the “Be Boring, Make Money” philosophy. Thanks for listening.