WisdomTree
RESEARCH

KILLING CONCENTRATION RISK IN CANADIAN STOCKS

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WISDOMTREE®

CANADA'S FEE QUANDARY

Morningstar's *2017 Global Fund Investor Experience Study* found Canadian equity funds' asset-weighted median expense ratio is 2.23%. It concluded:

"Canada scores poorly in Fees and Expenses, receiving a Bottom grade."

It goes on: "The median asset-weighted expense ratio for equity funds is the highest in this report." *The highest among 25 countries.*

Yet even today, Canadian ETFs still represent only about one-tenth of mutual funds' asset base. Figure 1 is telling.

FIGURE 1: Expense Comparison—Median Fund vs. DGRC

Name	Management Expense Ratio (MER)	DGRC Discount to Morningstar Median
Canadian Equity Funds Asset-Weighted Median	2.23%	
WisdomTree Canada Quality Dividend Growth Index ETF (DGRC)	0.24%	-89.2%

Sources: WisdomTree, 2017 Morningstar Global Investor Experience Survey. MER as reported on the Fund's latest Management Report of Fund Performance.

PUT WISDOMTREE'S 50 AGAINST THE TSX 60

The WisdomTree Canada Quality Dividend Growth Index ETF (DGRC) is part of our ETF suite that screens by three factors:

+ **Return on assets (ROA)**
+ **Return on equity (ROE)**
+ **Projected earnings growth**

After selecting the 50 highest-ranked Canadian firms by these metrics, we weight them by the dollar amount of their dividends, not by their market capitalization.

If a company pays a $1 billion dividend and the total paid by all companies is $40 billion, that company will be 2.5% of WisdomTree's 50 stock Index. This is a modification of cap-weighting and its beauty lies in avoiding concentration in stocks that have already rallied. Instead, the Index adds to companies whose dividends become a greater portion of the pie, regardless of what the market thinks.

The combination of profitability, growth and valuation metrics allow DGRC to go head-to-head with the S&P/TSX 60 Index, the S&P/TSX Composite Index and the MSCI Canada Index by directly confronting those indexes' concentration plague.

THE CONCENTRATION RISK PLAGUE

In Canada, the top-heavy stock market causes dangerous top heaviness for anyone whose funds or ETFs look anything like the S&P/TSX Composite, which has the same banks and Big Oil exposure as ten years ago, ten years before that and ten years before that.

As money flowed into ETFs, where did it go?

More ETF assets track the S&P/TSX 60 in this country than anything else, that's where. Capital left expensive mutual funds for ETFs that own the same companies. Fully 29% of the S&P/TSX 60 is taken up by the Big Five (RBC, TD, BNS, BMO and CM), not to mention significant chunks in Brookfield, Manulife and the rest.

Some diversified portfolio that is.

This is concentration of the most dangerous sort—providing a false sense of safety because the S&P/TSX 60 covers the "broad market." The problem is that so many of the big holdings are in common business lines.

Contrast it with DGRC, which cares only about rules-based merit. It isn't going to own the Bay Street giants just because of industry peer pressure.

Compare our top 10 with the S&P/TSX 60 (figure 2). Granted, our screen picks up all three telecoms in size, but only because when Suncor, Enbridge and the big banks are out, *something* has to move to the top of the list.

FIGURE 2: Top 10 Holdings

WisdomTree Canada Quality Dividend Growth Index	Weight	Sector	S&P/TSX 60 Index	Weight	Sector
PEMBINA PIPELINE CORP	5.33%	Energy	ROYAL BANK OF CANADA	8.46%	Financials
MAGNA INTERNATIONAL INC	5.18%	Consumer Discretionary	TORONTO DOMINION BANK	8.19%	Financials
SUN LIFE FINANCIAL INC	5.12%	Financials	ENBRIDGE	5.82%	Energy
CANADIAN NATL RAILWAY CO	5.06%	Industrials	BANK OF NOVA SCOTIA	5.50%	Financials
THOMSON REUTERS CORP	4.98%	Industrials	CANADIAN NATIONAL RAILWAY	4.79%	Industrials
ROGERS COMMUNICATIONS INC-B	4.94%	Comm. Services	SUNCOR ENERGY	4.51%	Energy
BCE INC	4.92%	Comm. Services	BANK OF MONTREAL	3.69%	Financials
POWER FINANCIAL CORP	4.90%	Financials	BCE	3.08%	Comm. Services
TELUS CORP	4.84%	Comm. Services	TRANSCANADA CORP	3.06%	Energy
RESTAURANT BRANDS INTERN	4.78%	Consumer Discretionary	BROOKFIELD ASSET MGMT	2.97%	Financials

Sources: WisdomTree, S&P, Bloomberg. Data as of 2/1/19. Weights subject to change.

Ask this: which top 10 list is more indicative of the Canada we all know? Is it the pipelines and rails and telecoms and restaurants and insurance and autos and diversified commerce across a vast land mass? Or the list of firms that are a three-minute walk from Union Station?

A TOTAL MARKET OFFERING

The WisdomTree Canada Quality Dividend Growth Index (WTCDG) covers large, mid and small caps, so it can cover your portfolio's entire Canadian equity sleeve (figure 3).

FIGURE 3: Market Capitalization, WisdomTree's Canadian Equity Approach

Market Capitalization	WisdomTree Canada Quality Dividend Growth Index	MSCI Canada Index	S&P/TSX 60 Index
Number of Holdings			
Large	28	67	53
Mid	12	24	6
Small	10	0	1
Market Capitalization Distribution			
Large	81.6%	94.2%	97.9%
Mid	14.7%	5.8%	1.9%
Small	3.7%	0.0%	0.1%

Sources: WisdomTree, Bloomberg. Data as of 2/1/19.

Importantly, even though WTCDG is unique, it still has correlations of 0.96 and 0.95 to the S&P/TSX 60 and the MSCI Canada, respectively. This is because it is still "broad Canada," even though its composition is unique.

DIGGING INTO THE FUNDAMENTALS

In figure 4, WTCDG's 50 stocks show up frequently in the top fundamental row.

FIGURE 4: Canadian Core Equity Index Fundamentals

	Dividend Yield	Implied Dividend Growth	P/E (ttm)	P/E Ratio (fwd)	Price/Book	Price/Sales	ROE	ROA
Most Desirable	WTCDG (4.14%)	S&P/TSX 60 INDEX (6.4%)	WTCDG (14.0)	WTCDG (13.5)	MSCI CANADA IMI (1.73)	WTCDG (1.20)	WTCDG (16.0%)	WTCDG (2.7%)
	S&P/TSX 60 INDEX (3.26%)	WTCDG (6.2%)	S&P/TSX 60 INDEX (15.6)	S&P/TSX 60 INDEX (13.6)	S&P/TSX 60 INDEX (1.85)	MSCI CANADA IMI (1.58)	S&P/TSX 60 INDEX (10.5%)	MSCI CANADA IMI (1.2%)
Least Desirable	MSCI CANADA IMI (3.10%)	MSCI CANADA IMI (5.9%)	MSCI CANADA IMI (16.8)	MSCI CANADA IMI (14.3)	WTCDG (2.26)	S&P/TSX 60 INDEX (1.75)	MSCI CANADA IMI (9.1%)	S&P/TSX 60 INDEX (1.2%)

Sources: WisdomTree, Bloomberg. Data as of 2/4/19.

Note the second column. Implied dividend growth is a function of the amount of earnings retained and ROE, which measures profitability. WisdomTree's Index has a yield north of 4% and, if current ROEs project to the future, dividends would grow about 6%. The S&P/TSX 60 would also seemingly grow the dividend about 6%, but its starting point is nearly a percentage point of yield lower, making it hard to catch up.

For investors who are comfortable with perhaps 70% of their Canadian equities in three sectors (figure 5), look elsewhere. For others, DGRC is worthy for the thoughtful among us.

FIGURE 5: Canadian Equity Index Sector Weights and Broad Fundamentals

				MSCI Canada Index			
		WisdomTree Canada Quality Dividend Growth Index	MSCI Canada Index	Price/Earnings Ratio (ttm)	Price/Earnings Ratio (fwd)	Price/Book Ratio	Price/Sales Ratio
Canada's 3 Biggest Sectors	Financials	18.9%	39.3%	11.4	10.2	1.61	1.61
	Energy	15.1%	20.2%	17.1	17.7	1.50	1.84
	Materials	6.7%	10.4%	24.4	18.8	1.30	2.16
	Sum	40.6%	70.0%				
Defensives	Communications Services	15.1%	3.2%	17.7	16.2	3.30	2.33
	Consumer Staples	6.0%	4.3%	20.7	16.9	2.65	0.52
	Utilities	0.0%	2.3%	26.3	16.3	1.22	1.79
	Health Care	0.0%	1.7%	-14.6	23.6	3.62	2.95
	Real Estate	0.0%	0.7%	14.7	N/A	1.05	6.66
	Sum	21.1%	12.2%				
Cyclicals (ex-Big 3)	Industrials	21.4%	9.1%	20.3	17.7	4.57	2.24
	Consumer Discretionary	14.0%	4.3%	13.5	12.2	2.90	0.98
	Information Technology	2.9%	4.5%	53.3	25.6	5.45	4.07
	Sum	38.4%	17.9%	16.8	14.3	1.73	1.58

Sources: WisdomTree, S&P. Weights as of 2/1/19. Percentages may not sum to 100% due to rounding. Fundamental valuations are for the MSCI Canada Index.

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