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Land of oligopolies: A compelling case for a heavy weighting in Canadian stocks

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Canadian investors are consistently told that the domestic stock market is full of pitfalls.

The professed shortcomings of the Toronto Stock Exchange are by now sorely familiar – it's overly exposed to natural resources; it's a poor approximation of a diversified market; it has too little representation in consumer, health care and technology names; and it has woefully underperformed the U.S. stock market over the long term.

That consensus has nurtured an inferiority complex of sorts, whereby minimizing exposure to Canada is seen as the first step in building a sound portfolio.

But there's an underappreciated segment of the Canadian market, separate from resources, that has generated superior returns and with less volatility than foreign alternatives. And it's growing steadily.

Welcome to the land of oligopolies.

Some key domestic industries have come to be dominated by a few large players sheltered by high barriers to entry, creating the conditions for reliably high profitability, and stock performance.

"The good news is that domestic investors do not have to stray beyond the TSX to own these excellent investment vehicles," Ian de Verteuil, head of portfolio strategy for CIBC World Markets, wrote in a recent report.

The report homes in on four concentrated sectors: banks, telecoms, railways and grocers, which together account for 34 per cent of the market capitalization of the S&P/TSX Composite Index, overshadowing the 29-per-cent share now claimed by energy and materials stocks.

The profile and track record of investable oligopolies makes a compelling case for a healthy weighting in Canadian stocks, Mr. de Verteuil said.

"Canadian investors should not simply assume the best investment strategy is to reduce exposure to the S&P/TSX Composite Index."

With a relatively small population spread over a vast terrain, the Canadian economy seems to be a natural incubator for oligopolies.

Anthony Lacavera, who founded Wind Mobile in a bid to crack the telecom oligopoly before eventually selling the company to Shaw Communications Inc., described the Canadian economy's high level of industry concentration:

"Six companies dominate the Canadian banking industry. Four companies dominate the internet-service-provider market. Three companies dominate English-language television broadcasting, the supermarket industry, and wireless telecommunications. A duopoly dominates the airline industry. And so on. Oligopoly players are fat and happy," Mr. Lacavera said in his recent book, How We Can Win, co-written with author Kate Fillion.

There are legitimate concerns over this kind of industry structure from a consumer perspective. Canadian wireless prices consistently rank higher than in other developed economies, although telecom incumbents suggest their pricing reflects levels of investment in their networks spanning a very large country. Canadians also tend to pay relatively high banking and investment fees.

As investments, however, oligopolies can be absolute stars.

"You're looking for industries where competition is not quite as fierce," Dennis Mitchell, chief executive of Starlight Investments Capital, said in an interview. "When competition gets to the point where it's just a cutthroat race to zero, it's difficult for the incumbents to exercise pricing power."

Quite the opposite for the Big Six banks, for example, which together generated $45.3-billion in earnings last year, amounting to more than $1,200 for each and every Canadian.

Compared with U.S. counterparts, Canadian banks have been consistently more profitable, with an average total return on equity of 15.7 per cent over the past 20 years, compared with 11.6 per cent for banks in the S&P 500, according to the CIBC report.

Over that same time, Canadian telecom and railway profitability also exceeded U.S. peers, which Mr. de Verteuil suggested was because of higher concentration. The Canadian grocery segment, however, was an exception in falling a bit short of U.S. grocer profits over the past two decades.

Nonetheless, investments in any of the four Canadian oligopolies have been handsomely rewarded on average, relative to the broader stock market.

Over the past 30 years, all four have posted average annual total returns in the double-digits, ranging from 11.4 per cent for the telecoms to 13.9 per cent for the rails. Over that time, the S&P/TSX Composite returned an average of 8.2 per cent.

“It will not be lost on anyone that the rails have the highest apparent level of concentration – and the highest compounded returns,” Mr. de Verteuil said.

Not only were stocks in concentrated industries more rewarding than the rest of the market, they were also more stable, he added. “The conclusions are clear: These sectors offer better returns with less volatility.”

While oligopolies might make the Canadian stock market more attractive, they do not save it entirely. There are still plenty of risks in sticking too close to home, and there are entire sectors in short supply, Mr. Mitchell said. There are just 10 tech names in the S&P/TSX Composite, for example, adding up to about $109-billion in market capitalization, which is considerably smaller in its entirety than Nvidia Corp., a single U.S. chipmaker.

But the land of oligopolies perhaps deserves more credit than its many detractors give it.

“As long as it’s within those sub-sectors that are dominated by oligopolistic industries, this lends itself to an overweight in Canada,” Mr. Mitchell said.

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