

## **TSX investors, hope you enjoyed the ride. Soon you'll have to use your head**

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You can put a price on almost anything -- real estate, cars, employees, executives. Billy Beane, the incomparable general manager of the Oakland Athletics, has made a career of putting a price on baseball players, then trying to get the undervalued ones. It's the only way he can keep his low-budget team in the race.

But can you put a price on an economy? If so, Canada is worth about \$2-trillion.

That sum of money is hard for any of us imagine. It's equal to the net worth of the Thomson family, 85 or 90 times over. It's more money -- quite a bit more -- than the combined wealth of the world's top 100 billionaires. If you were born with such an inheritance and spent a million dollars every hour, you'd need to have the longevity of Methuselah to deplete it.

Yet \$2-trillion dollars is what Canada's public companies are worth on the Toronto Stock Exchange. (The real number was \$1,926,080,381,703 at the end of April, but what's \$74-billion between friends?) And if you want to know why the domestic equity market has been faltering lately -- the S&P/TSX composite is down 3.2 per cent since April 21 -- the \$2-trillion figure is as good a place as any to start.

Though investing is often made out to be complicated and heavy textbooks are written about the subject, the performance of any stock (or group of stocks) is a function of only two things: profits, and how much investors will pay for profits. The latter is determined mainly by interest rates. Economic growth, by itself, doesn't have much to do with it. America's economy grew rapidly from the mid-1960s to the early-1980s, despite oil shocks and periods of stagflation in the 1970s, yet U.S. markets did little but move sideways. Why bother buying stocks when you can own government bonds and make 18 per cent?

So the fuel for stock market gains comes from four sources. Companies have to earn more because of (a) growth in the economy or (b) their profits capture a bigger share of gross domestic product (GDP). Alternatively, investors have to be willing to pay more for a dollar of earnings because (c) bonds are unattractive or (d) they undergo a psychological change in how they view risk -- they go from being unduly pessimistic to more optimistic.

With those criteria in mind, let's examine the future for Canadian stocks:

- (a) The economy is growing at a rate of more than 3 per cent. There's room to go faster, but it's already pretty strong.
- (b) Canadian corporate profits, as a proportion of GDP, are extraordinarily high by historical standards. There's little room to go up.
- (c) Bonds still don't pay much; a 10-year Canadian government bond yields 4.45 per cent. But since last September, the trend for yields has been in one direction: higher.
- (d) Psychology is harder to measure, but judging from stock market multiples, there's no evidence Canadian investors are suffering through a bout of irrational pessimism.

So what's left to propel the TSX?

Everyone knows it's dangerous to invest in a company where the price is getting too far ahead of the earnings. What's true for stocks is true for markets. At the peak of equitymania, in March, 2000, the market capitalization of U.S. stocks rose to 190 per cent the country's gross national product, far above the norm. It was a warning sign of trouble to come.

The TSX does not look like the Nasdaq did then. But domestic stock market values are rising much more rapidly than economic production. Toronto's market capitalization -- that \$2-trillion -- has *doubled* since the end of 2002 and is equal to 135 per cent of Canada's GDP (not adjusted for inflation). The 278 companies of the TSX are worth almost as much the nation's economy (see chart).

This is unprecedented, and it suggests the splendid returns of the past three years won't be repeated -- not even close. It doesn't mean, by the way, that individual investors won't or can't make money. Peter Puccetti, one of the smartest hedge fund managers we know (with a record to prove it), says he feels like "a kid in a candy store," even though he owns no copper, no gold, no energy stocks. Why? Because outside of those favourite sectors, companies are getting cheaper all over the place: 148 stocks in the Russell 2000 have lost more than 30 per cent of their value in the past year.

That's happy news for skilled stock pickers like Mr. Puccetti. But that's what they are -- pickers. Riding the TSX index has worked for a few years. It's about to become yesterday's strategy.