Stock indexes are tricky to compare

We often hear "the market" being cited in the media, but what exactly are they referring to?

Typically, a proxy is being referenced like the S&P 500 in the U.S. or the TSX Composite in Canada. Both indexes tend to weight the largest companies the most, but are very different in their composition. This has significant consequences when comparing things like risk and return. Let me explain.

The TSX Composite is highly exposed to the returns of a few sectors. The financials, energy and materials sectors make up more than two-thirds of the entire index. Generally speaking, when commodities are doing well "the market" in Canada is doing well. The TSX Composite is up about 13 per cent so far this year, but more than 60 per cent of this return is attributable to commodity stocks (many of which are very volatile). Gold stocks have made headlines this year and lifted the market, but are still down more than 40 per cent on a price basis from their peak in 2011. Likewise, energy stocks have come back in 2016, but are also well off their highs, down about the same on a price basis since 2014.

If you also include the heavily weighted financial sector, which commands a 36 per cent weight in the index, then you can explain more than 97 per cent of the year-to-date return. The reason for this is the disproportionately large weights commodity and financial stocks have in the TSX Composite.

Valeant made headlines in 2015 when it became the most valued company in Canada by market capitalization, ballooning to about six per cent of the entire index. At its height that year, the TSX composite was up two per cent, but Valeant was up a whopping 94 per cent! If you had removed the effects of Valeant at that time, you would have found that without this one stock's contribution, the TSX Composite would have actually been down about 2.4 per cent. That's a big difference.

The U.S. market, as represented by the S&P 500, is much more balanced in its composition. Technology is the largest weight in the index, representing about 21 per cent of total market capitalization. But you also have five other sectors representing between 10 and 16 per cent each, which means no one sector or stock can have the impact that say the financials or Valeant can have in Canada. Technology stock valuations went to unrealistic levels in the late 1990s and the sector did run to a high of 34 per cent of the S&P 500, but that was a bubble and is the exception to the rule. In Canada, this type of outsized impact is commonplace.

Comparisons between the TSX Composite and the S&P 500 are apples-to-oranges because of differences in sector composition and should be avoided. In Canada, the volatile commodity sector is lifting the Canadian market far more than our U.S. counterparts because of this dynamic. Going underneath the hood and analyzing the drivers of return shows that a majority of the return this year on the TSX Composite has been driven by commodity stocks, which tend to be risky ventures – just ask anyone who has held onto their gold stocks since 2011 or energy stocks since 2014.

Lori Pinkowski is a senior portfolio manager and senior vice-president, Private Client Group, at Raymond James Ltd., a member of the Canadian Investor Protection Fund. This is for informational purposes only and does not necessarily reflect the opinions of Raymond James. Past performance is not necessarily indicative of future performance. Lori can answer any questions at 604-915-LORI or lori.pinkowski@raymondjames.ca. You can also listen to her every Monday morning on CKNW at 8:40 a.m.