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Canadian dispersion

A normalisation of returns across North American equities may prove supportive of MCT...

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Readers are unlikely to be surprised that 2023 saw a highly concentrated pool of companies delivering outperformance for North American equities. Fully 65% of the S&P 500's returns were driven by just ten stocks.

A consequence of this was that only 28% of companies in the index delivered above average returns last year, the lowest level since the late 1990s and far below the 49% median since 1991. In fact, there have been just three years, apart from 2023, when the figure was below 40% - 1998, 1999, and 2021. Make of that what you will.

Canadian equities have also seen a narrower set of companies driving returns, but this has been far less extreme than the US. Indeed, the US and Canadian markets are so correlated that the concentration in the former has arguably been a major cause of the lower valuations we see in the latter.

To give one example, financials companies in the TSX Composite Index were trading at a forward earnings multiple that was almost 30% below the five-year historical average as at 10/04/2024. This is despite the fact that companies in the sector continue to deliver robust earnings and dividend growth.

In addition, almost three-quarters of companies in the sector are forecast to deliver dividend growth in excess of the rate of inflation in Canada in the next year. Even for those that aren't hitting that growth level, the 12-month forecast yields on offer look strong relative to free cash flow yields and are almost all above the yield on government bonds. For example, the Bank of Nova Scotia is forecast to increase dividends by 2.1% over the next year, but that represents a 6.1% yield on the current share price.

It is hard to not see these sorts of features become more attractive to investors. The market concentration we saw last year seems so extreme that any mean reversion would likely benefit these sorts of companies.

A knock on effect of that could be positive performance for **Middlefield Canadian Income (MCT)**. The trust is one of the only closed-ended funds that provides dedicated exposure to the Canadian stock market, with an objective of delivering a high level of dividends and capital growth to shareholders. The trust's discount was trading at a near 20% discount to NAV as at 10/04/2024, or a 1.75 standard deviation below its five-year historical average.

In large part, that is a reflection of the skewed dynamics described above. But even accounting for market concentration, many of the companies MCT invests in have had a tougher period over the last 12 to 18 months.

That is primarily due to fears about the impact that interest rate hikes will have. For example, the trust currently has a nearly 30% weighting to real estate via investments in real estate investment trust (REITs) holdings.

Some of these themselves are trading on steep discounts. For example, Riocan Real Estate Investment Trust is one of MCT's top holdings and is trading almost 25% below its book value.

Is that justified? As with financials, another sector MCT has sizeable exposure to, most REITs have held up well, despite higher rates and inflation. As MCT

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manager Dean Orrico noted when we spoke to him last year, REITs have, for the most part, been able to mark up lease rates in line with inflation or in excess of it.

At the same time, Canada is experiencing an immigration-fuelled population boom, with – as of yet – little commensurate increase in the housing stock. This has helped support rents across both commercial and residential properties. Nonetheless, rate-hike driven fears have compressed valuations and, as noted, led to a substantial widening of the MCT discount.

We think a couple of factors mean the trust sits an interesting juncture as a result. Mean reversion in returns dispersion may take place. Indeed, it is hard to see how such a small number of companies can continue to drive the market over the long term.

We also think the fundamentals will be supportive of that trend, at least as it pertains to the more value-oriented, income stocks that MCT invests in. Many of the fears investors have are understandable but they have arguably been more knee jerk reaction, rather than being based on the facts on the ground.

As the German expression goes – lies have short legs. In this case it feels like the opposite is true. So long as earnings and income growth remain strong, it is hard to see how the wider market can simply ignore the returns potential these companies offer. Were that to happen then it's plausible investors in MCT would enjoy enhanced returns, as they stand to benefit from both underlying performance and a tightening of the discount.

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