

The TSX Index

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The TSX Index – Positive, But Misleading

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As we're almost half way through 2008 we've seen a stark difference in returns between the TSX Index and three major indices in the United States including the Dow Jones Industrial Average, the S&P 500 and the Nasdaq. As of June 18, 2008 the TSX has posted a simple return (excluding dividends) of 7.5% while U.S. markets have fallen between 7% and 9%. How can it be that the equity markets for Canada's largest trading partner are struggling while the TSX is in positive territory? The answer can be summed up in one word...Resources.

Many investors compare their portfolio performance to the TSX Index. While comparing performance to a benchmark such as the TSX is not wrong in theory, it can be a poor comparison for those investors with portfolios that do not resemble the make up of the benchmark.

What some investors are not aware of is the fact that the TSX is a market capitalization weighted index. This means that the larger the market cap of a company, the larger the weighting of that company within the index. As an example, if I had an index of two stocks where the market cap of one stock is \$10 million and the market cap of the other is \$5 million then I would have an index that weights 67% of the first stock and 33% of the second. Naturally, as market caps change, so do the weightings of each stock within the index. The adjacent chart shows the weightings of the top 20 weighted stocks in the TSX as of June 18, 2008.

TSX Index - Top 20 largest Weightings

Name	Ticker	Weight %
1 Potash Corp of Saskatchewan	POT	4.832
2 EnCana Corp	ECA	4.529
3 Research In Motion Ltd	RIM	4.505
4 Royal Bank of Canada	RY	4.095
5 Suncor Energy Inc	SU	3.798
6 Canadian Natural Resources Ltd	CNQ	3.683
7 Manulife Financial Corp	MFC	3.668
8 Toronto-Dominion Bank	TD	3.449
9 Bank of Nova Scotia	BNS	3.193
10 Barrick Gold Corp	ABX	2.311
11 Goldcorp Inc	G	1.905
12 BCE Inc	BCE	1.802
13 Petro-Canada	PCA	1.772
14 Sun Life Financial Inc	SLF	1.622
15 Canadian Oil Sands Trust	COS.un	1.605
16 Canadian National Railway Co	CNR	1.571
17 Canadian Imperial Bank of Commerce	CM	1.561
18 Talisman Energy Inc	TLM	1.524
19 TransCanada Corp	TRP	1.484
20 Rogers Communications Inc	RCI.b	1.452
Total		54.361
Weighting of Remaining 236 stocks in the Index		45.639

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The chart on the previous page shows large cap companies in Canada dominate the TSX as the top 20 stocks make up 54.4% of the Index while the remaining 236 stocks account for 45.6%. In fact, the top 6 stocks alone make up a quarter of the Index. Such market weightings are reminiscent of the tech days of earlier this decade when Nortel Networks dominated the index.

If you do not own many of the stocks listed above, then it will be difficult for the performance of your portfolio to match that of the TSX. But matching the performance of the TSX is not what should be important to you as an investor; instead you should remain focused on your long term plan and investment goals. To match the index would require an investor to switch in and out of stocks and sectors on a regular basis. As of right now, it would require investors to weight 49% of their portfolio to resource stocks (Energy and Materials) which might offer capital appreciation but less investment income. Would such a strategy be appropriate for a conservative investor who depends on his/her portfolio for investment income and is concerned about capital preservation? No, it would not.

Investors that map out a long term plan must understand that their holdings will never be the top performers all of the time. The stock market is cyclical, therefore individual portfolios are cyclical. The performance of each individual stock within a short period of time is less important than the performance of the portfolio as a whole and the eventual accomplishment of longer term investment objectives.

To show why the TSX has outperformed the United States we list below the weighting of each TSX sector and its contribution to performance in 2007 and 2008 as of May 31:

TSX Index - Sector Weightings and Performance

Sector	% Weight in the Index	Contribution to 2007 Performance	Contribution to 2008 Performance
Energy	32.048	27%	89%
Financials	25.843	-2%	-14%
Materials	19.212	28%	38%
Technology	5.445	26%	3%
Industrials	5.064	7%	6%
Telecommunications	4.634	13%	-7%
Consumer Discretionary	3.689	2%	-13%
Consumer Staples	2.197	0%	-2%
Utilities	1.523	2%	1%
Health Care	0.345	-4%	-2%

The one number that stands out is that 89% of the point gains by the TSX index this year can be attributed to the Energy sector. The fact that energy stocks have traded higher should come as no surprise due to the price increases we've seen for crude and natural gas. In order to match the performance of Energy in the TSX index, investors would have to have at least 30% of their portfolio in energy stocks. For some investors such a strategy may be appropriate, but for others such a strategy may limit an investor's ability to meet their long term goals.

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One last process we'll look at to show how biased the TSX is to very few names is to evaluate the point contributions by individual stocks to the Composite Index. To June 18th, the following are the top 10 point contributing stocks to the TSX in 2008:

Largest Point Contributors to the TSX in 2008

Stock	Ticker	\$ Change YTD	Point Contribution YTD	% Point Contribution
Potash Corporation of Saskatchewan	POT	\$ 100.40	303	24.2%
Encana	ECA	\$ 29.52	212	16.9%
Canadian Natural Resources	CNQ	\$ 37.05	191	15.3%
Research in Motion	RIM	\$ 32.45	147	11.7%
Suncor	SU	\$ 12.66	112	8.9%
Canadian Oil Sands Trust	COS.un	\$ 15.66	72	5.8%
Fording Canadian Coal Trust	FDG.un	\$ 54.81	63	5.0%
Agrium	AGU	\$ 40.56	61	4.9%
Talisman	TLM	\$ 6.00	58	4.6%
Teck Cominco	TCK.b	\$ 13.86	58	4.6%
Top 10 Total			1277	102.0%

Total point change thus far in 2008 for the TSX Index: +1251.79

As you can see above, TSX performance has been dominated by a small number of stocks. In fact the top 10 point contributors are responsible for 102% of this year's gains alone which means that negative returns from other stocks have offset the gains by the top 10. Considering that the TSX is up 7.5% thus far in 2008, it would be easy for an investor to conclude that a majority of stocks that make up the TSX would be higher, but that would be wrong. Due to the higher weighted stocks moving up and more lower weighted stocks moving down, only 125 stocks have advanced this year while 139 have declined and 2 are unchanged (including stocks that may no longer be in the index or may have been bought out since the beginning of the year).

We have provided this report to illustrate that the positive returns from Canada are not all that they seem and that strength has not been broadly based across all stocks and sectors. It also emphasizes the need for investors to understand the composition of their equity portfolios, how they compare to the composition of the TSX Index, and more importantly how their portfolios are structured to meet their long term investment goals. For further discussion about your portfolio, please contact your ScotiaMcLeod Wealth Advisor.

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