Top Dogs? **Downward Dogs.**

STEPHEN ROGERS, INVESTMENT STRATEGIST, I.G. INVESTMENT MANAGEMENT

"**Uneasy** lies the **head** that **wears a crown.**"
(William Shakespeare, Henry IV, Part 2 [Act III, Scene I])

As troubling headlines piled up for Valeant Pharmaceuticals in the first quarter of 2016 many Canadian investors felt they'd seen this movie before. The stock price of the company that became Canada's largest company by market capitalization in July, 2015 was crumbling, leaving both retail and institutional investors dazed, confused, and considerably less wealthy. Across the land came a collective sigh, "not again."

It was not just investors asking what was going on. The National Post questioned why such implosions seemed to happen at a higher frequency in Canada than they do elsewhere, and observed "the history of our exchange is littered with onetime giants turned into shadows of their former selves – some walking, some not." (Blackberry, Valeant's spectacular collapses a familiar story for Canada's stock market darlings, National Post, April 6, 2016)"

In fact, so well recognized is the phenomenon, that less than one week after Valeant claimed the top market-cap perch back in July 2015, Maclean's magazine asked "will it succumb to the curse of being the biggest company in the land?" To anyone familiar with the history of Canada's stock market, the answer was almost certainly yes.

The so-called "winner's curse" is widely recognized, and does indeed seem to happen more frequently in Canada. And when it does happen here it matters more. How persistent is this misfortune? What causes it? Why are Canadians so prone to the experience? First some background and a bit of history.

The Winner's Curse

In 2012 Rob Arnott and his associate Lillian Wu of Research Affiliates, LLC published a study paper entitled "The Winner's Curse: Too Big To Succeed?" that looked at the world's biggest stocks by market capitalization from 1952 to 2011 and put numbers on their track record. They found a remarkably persistent pattern of companies, once achieving "top dog" status, underperforming over the next 1, 3, 5, and 10 year time horizons. Sector top dogs underperformed their sector peer groups, country top dogs underperformed their benchmark country indices, and global top dogs underperformed global markets. Across the nine developed countries they studied, they found the phenomenon held in each and every market.

On average, country top dogs in Arnott's study underperformed their respective country's equal-weighted index by 4.3% per year for the following decade (1 year -3.5%, 3 years -4.0%, 5 years -4.9%). This is not a trivial amount when compounded for ten years. What's more, the underperformance typically began within one year of achieving top dog status and became relentless.

Even more troubling for Canadian investors, of the nine developed country markets studied by Arnott and Wu, top dogs in Canada posted the worst average relative performance: -10.0% per year for the following decade. (It would be interesting to see how this would compare if Nortel had not been in the sample.)

Almost by definition, top dogs would be expected to have outperformed impressively in the years leading up to their claiming the title – success is what gets you to #1. But contrary to the popularly held notion that as the 'law of large numbers' takes hold these companies gradually lose their ability to grow quickly, Arnott and Wu found that the fall from the throne typically was as quick and dramatic as was the rise to it. Figure 1 illustrates their findings for the five years before and after companies became most valuable in their markets.

In a simpler and more limited look at the tendency for market giants to underperform, The Economist compared average returns, ten years before and ten years after claiming leadership status, of companies that led the S&P 500 by market cap between 1993 and 2005. ("The Curse of the top dog", March 7, 2015)

The four firms that held the title during this period were IBM, Exxon, General Electric and Microsoft. In the ten years preceding their ascendency, the firms' average total return was 1282% versus 302% for the S&P 500 over the corresponding periods. For the ten years after they averaged 125% versus 199% for the index (Figure 2).

FIGURE 1

Relative Performance, Developed Top Dogs, Before and After Top Dog Status

SOURCE: "THE WINNERS CURSE: TOO BIG TO SUCCEED?", ARNOTT & WU, 2012

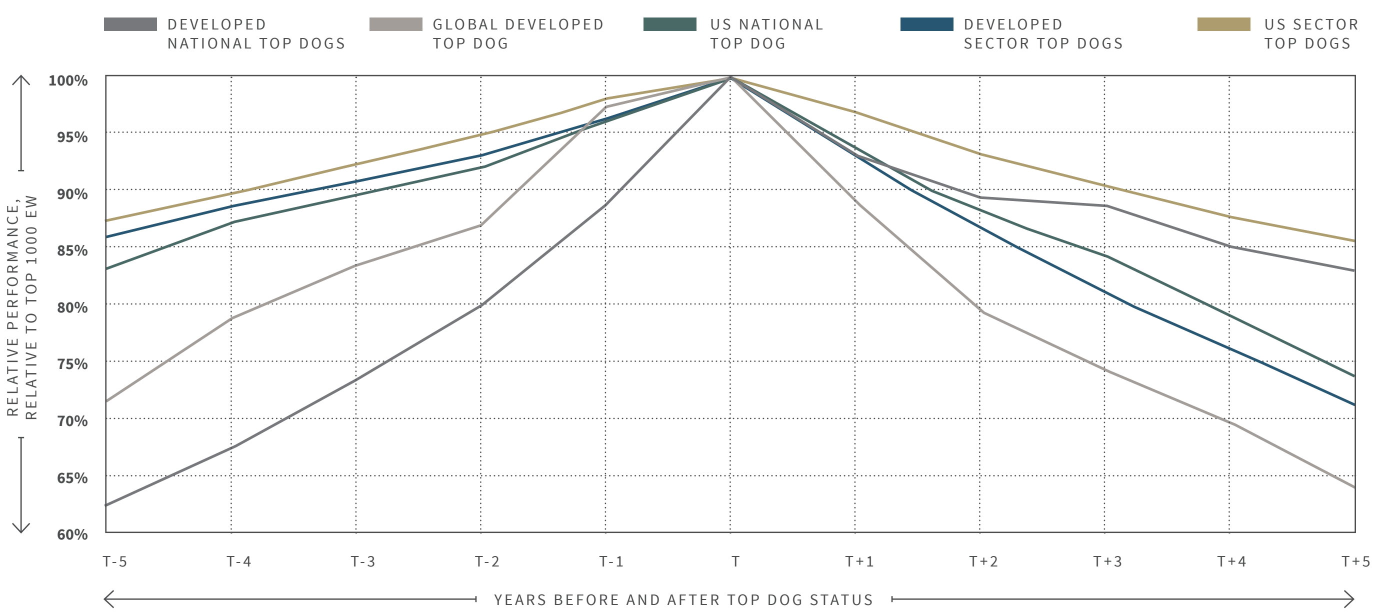
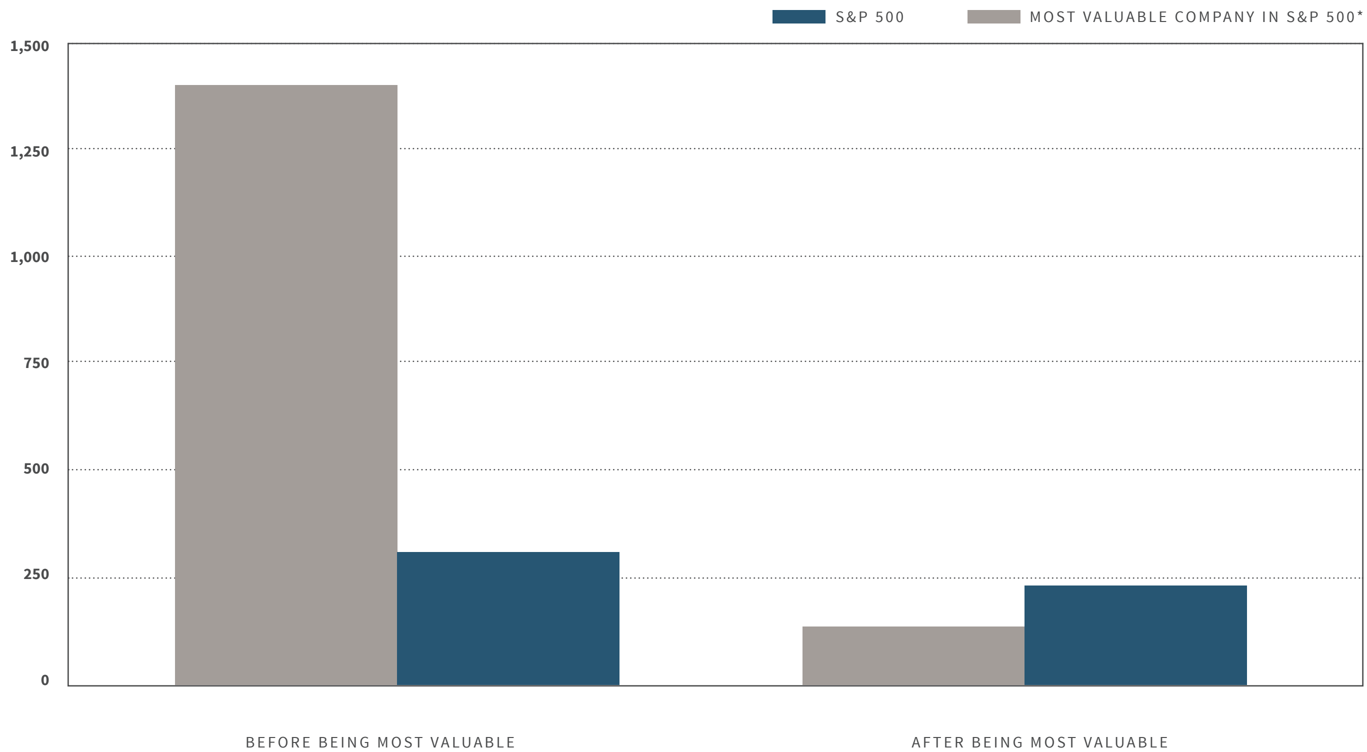


FIGURE 2

Average ten-year total return, 1983-2005, %

SOURCE: THOMSON REUTERS; THE ECONOMIST



*IBM, ExxonMobil, GE and Microsoft

What is happening?

As the Economist puts it, the simplest explanation is that the top dogs reached the summit due to rapid growth and a widely admired business model. As investors consequently pushed up valuations, the stock prices simply became more vulnerable to disappointment. Disappointment could come from faltering profits or anything that cast doubt on the long term growth potential. Furthermore, size can bring with it dis-economies of scale, or firms may simply encounter the 'law of large numbers', which asserts it's harder to double sales from $1 billion to $2 billion than it is from $1 million to $2 million, let alone from $100 billion to $200 billion.

Arnott saw it differently: "When you are #1, you have a bright bull's-eye painted on your back."

Targeted by new competition

Success attracts new competition. But managing and growing a large business is in many ways more difficult than growing a small one. Higher fixed costs and established infrastructure hampers flexibility. Management may fall prey to internal rivalries or external distractions further restricting the ability to react nimbly to new challenges. Challenges from newer, nimbler competitors in niche markets may also raise the "innovators dilemma" (Clayton M. Christensen, The Innovators Dilemma, Harvard Business School Press, 1997), where too much attention to current customers leads to a failure to adopt new technologies or practices required to serve new or future customers.

Scrutiny of regulators

Rapid growth, especially if it leads to perceived market dominance, can put a company squarely in the sights of regulators (who have often been egged on by resentful competitors). Microsoft became such a target in the late 1990s with the Justice Department launching an anti-trust case focused on product bundling, especially with regard to its web browser. In the early 1980s, AT&T was broken up over its business practices, creating seven new 'Baby Bells'. More recently the 2008-2009 financial crisis led to many cases of civil and criminal charges, fines and penalties aimed at financial institutions including Goldman Sachs, Bank of America, Citigroup, and others. While many firms and individuals deserved to be punished, the actual targets and penalties imposed have been viewed by many as unfair, populist political scapegoating. Alphabet (Google), which reigned briefly in early 2016, has recently faced repeated regulatory inquiries, especially in Europe. As Arnott explains,

> "The very business practices that propel an organization to **#1** in market cap – **aggressiveness**, **focus**, canny **outmaneuvering** of **the competition** – become **unacceptable** if you're wearing the **yellow jersey**."

The Curse of the cover

The idea that extensive mainstream media coverage was a jinx became popular first with the perceived misfortune or underperformance of athletes who appeared on the cover of Sports Illustrated magazine. The idea then migrated to business as reflected in cover subjects on magazines such as Fortune, Forbes, and Business Week. In both realms the generally accepted explanation is that some incidence of extreme or outlier performance is what propels athletes or businesses to the cover, and that a simple regression to the mean of subsequent performance looks naturally disappointing by comparison.

But in business there is definitely more to it than that. Vaulting to the top of the market cap tables and garnering the resulting attention likely means more Wall Street and Bay Street analysts begin research coverage of the stock to serve their client base, more of whom now own the stock. Wider coverage means a broader scope of published opinions, some of which may take contrarian views. More eyes on the finances and business fundamentals increases the chances that problems or potentially fraudulent activity, if present, are uncovered.

As a company's products or services become more popular and visible, they may develop cult followings, or perhaps become targets for environmental or social activists. These views and issues, both negative and positive, will likely be projected by some investors onto the stock price.

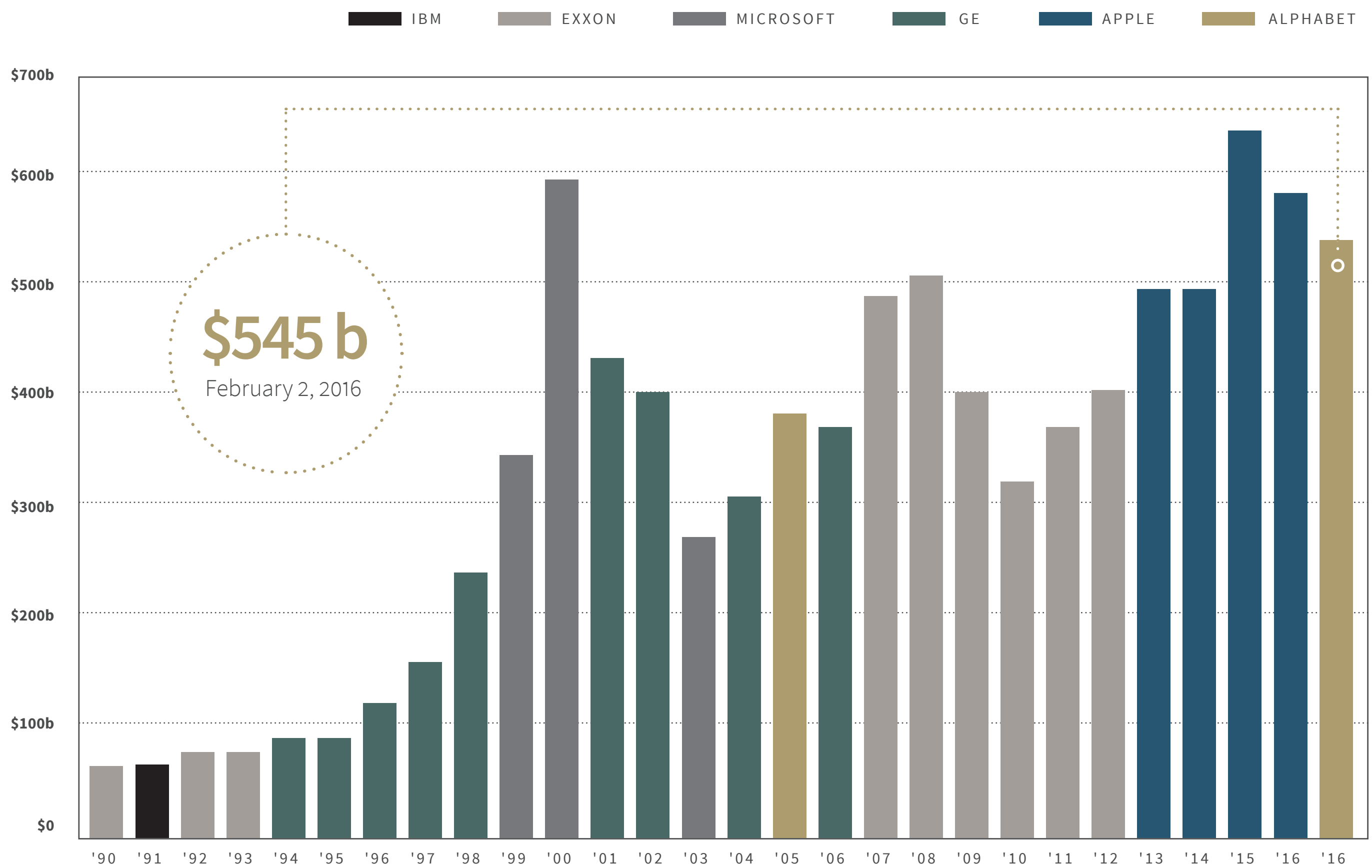
A changing breed.
Who are the top dogs?

Until the technology boom, or 'dot.com' bubble, of the late 1990s, the top market cap position in the United States was typically an industrial giant, with high capital spending requirements for factories and physical infrastructure. Names in this elite group included AT&T, General Motors, Dupont, Exxon (Standard Oil), International Business Machines, Wal-Mart, and General Electric. High capital needs created high barriers to entry protecting dominant businesses and made shifting relative sizes and position rankings a relatively slow process. It wasn't unusual for a top dog to hold that title for more than a decade.

FIGURE 3

Alphabet Follows in the Footsteps of IBM, Microsoft and Apple

SOURCE: BUSINESS INSIDER



Market caps are for January 1 of the representative year

The tech boom accelerated the pace of change and made changing the top position easier and more frequent. New technology can quickly disrupt market incumbents. Five companies have held the S&P 500 top spot in just the last 15 years (Figure 3). The list now includes IBM, Cisco Systems, Microsoft, Apple Computer, and most recently Alphabet (Google).

In Canada, however, the upper echelons of the market cap tables have long been dominated by the major banks and BCE, with Royal Bank of Canada perennially the one to beat (going back to the 1970s.) The commodity super cycle brought energy and resource companies into the top ranks along with our technology champions. Canada's top dogs since 2000 (other than Royal Bank) include Nortel Networks, Manulife, EnCana, Blackberry (Research in Motion), Potash Corp., Barrick Gold, and most recently Valeant Pharmaceuticals. Furthermore, this is not just a 21st century phenomenon: those in the industry long enough will remember the energy and gold booms of the 1980s elevating Canadian names like Placer Development and Dome Petroleum (at its peak in 1981, Dome represented roughly one quarter the weight of the Toronto Stock Exchange.)

The Ugly Canadians

Even to a casual observer, something distinguishes the Canadian list from the U.S. list apart from the presence of financials and resources. While no longer topping the market cap table, Exxon, IBM, GE, Microsoft and Apple all remain successful global giants. The Canadian champs? Not so much. Nortel and Valeant collapsed amid allegations of questionable bookkeeping and business practices. Blackberry has been crushed by global competition. EnCana, Potash and Barrick all succumbed to the down leg of the commodity cycle. Excluding Royal Bank, Canada's former champions have a less than impressive stock market record:

Nortel Networks Corp. (NT)

Nortel rode the wave of the dot.com/internet frenzy to a peak stock price of $123.10 in July, 2000. At a market cap of more than $400 billion it accounted for over a third of the value of the TSE 300 (as the S&P/TSX was known at that time.) Twelve months later the stock was worth less than 10% of that figure. It limped on until filing for bankruptcy in 2009 and restating earnings back to 1999.

Manulife Financial Corp. (MFC)

Manulife grabbed the top spot in April 2004 by acquiring and merging with John Hancock Financial Services. When the deal closed the stock sat at $27.50, then continued to climb until peaking at $44.19 in October 2007. Fifteen months later as the financial crisis dragged down markets around the world, and financial institutions in particular, MFC stock bottomed out at $9.20, a fall of 79% from its peak. It has since recovered to the high teens, still less than half its high water mark and more than 30% below its value when it closed the deal that vaulted it to the top.

EnCana Corp. (ECA)

EnCana briefly held the title of Canada's largest in 2006, courtesy of a surge in energy prices due to Hurricane Katrina. It claimed a more solid hold in March 2008 and reached its high of $51.71 in June of that year. Today it wallows just north of $4 a share, a decline of over 90%. (2008 was a turbulent time for TSX rankings, with Royal Bank, EnCana, Blackberry, and Potash taking turns in top spot.)

Blackberry Ltd. (Research In Motion) (BB, RIM)

Blackberry (or Research in Motion, as it was then known) pushed past Royal Bank on an intraday basis in October 2007, then made it more secure a few weeks later when it closed at $123.52 on November 7. The stock continued upward until June 19, 2008, closing at a high of $149.90 before reversing course under the pressure of global competition. Five years later the stock was more than 95% off its peak and struggling to survive.

Potash Corporation of Saskatchewan (POT)

Potash rode a wave of enthusiasm for agricultural commodities that took its stock from $30 (pre-split) in 2006 to $244 in June of 2008, giving it too, a top-dog moment in the sun. It now trades at less than one quarter its split-adjusted high.

Barrick Gold Corp. (ABX)

Barrick took the torch from EnCana January 23, 2009 closing that day at $48.79 and continuing its climb until December 10, 2010 when it closed at a high of $55.25. Five years later it was off more than 80% and trading below $10. A partial recovery in recent months has brought it back to roughly $20, still almost two thirds off its peak value

Valeant Pharmaceuticals (VRX)

Valeant passed Royal Bank to become the biggest company by market cap on the S&P/TSX on July 23, 2015 after an advance of almost 100% in the preceding year. Its price reached its all-time high less than two weeks later at $346.32. However it has experienced the most spectacular fall, losing 90% of its value in just eight months.

Why us?

I gotta get me a piece of that action…

Canada, like many markets, displays a distinct home country bias, for a variety of understandable reasons. Some feel that investing locally avoids unnecessary exposure to foreign exchange and geopolitical risks. Taxation and securities laws usually make participation in local markets far less costly or complex. Governments may provide tax incentives to individuals to invest in domestic firms. For many decades Canadian tax shelter vehicles such as RRSPs had strict foreign content limitations that helped make Canada's home country bias particularly strong. Market rules often treat foreign and domestic participants differently, or impose outright restrictions on foreign participants. Investors are usually far more familiar with local firms and their businesses, and can more easily access information about them upon which to base investment decisions. And many investors take stakes in shares of their employers, sometimes to directly share in the success of the enterprise they are part of, or possibly just because saving in that manner is made easier through employee stock purchase programs.

A less understandable element in home country bias is putting your future financial security at risk in a display of blind patriotism. Rather than basing investment decisions on company stock fundamentals or tax considerations, some investors buy stock in emerging domestic champions for no other reason than they are domestic, much like the way sports fans dogmatically cheer the home team, regardless of the team's merit. With a relatively small stock market (by developed country standards), Canada has so few true global champions Canadians tend to enthusiastically jump on the patriotic bandwagon whenever one appears. Sell-side analysts, who may feel pressured to offer a certain portion of their coverage list as "buys" versus "sells" or "holds" can be caught up just as easily as are their retail clients. Analysts, institutional investors and retail investors alike, may consciously or unconsciously turn a blind eye to what otherwise might be viewed as a red flag.

Because of the small size of Canada's market, a hot stock will have a big footprint on the index, further aggravating the problem as institutional equity funds pile in for fear of missing out on gains being experienced by competitors.

> As **Nortel** streaked to its highs before the bursting of the tech bubble, it **came to dominate** the **Toronto stock market** index so completely (over 36% of the index by weight at one point) many **mutual funds** and **pension funds** came under severe **pressure from unit holders** who questioned why their **investments** were so badly **underperforming** the **benchmark** index.

Everybody hurts

When a Canadian top dog topples from its perch, there is often no escaping the pain. The size and concentration of the market not only contributes to more frequent stock implosions as described above, but makes them matter more when they do happen. Domestic bias happens in all markets, but in a broader market such as that in the U.S., investors have a much greater natural level of protection by diversification.

If almost all equity funds, whether they be mutual funds, pensions, endowments, etc., participate in the rise of a domestic stock market darling as it comes to dominate the benchmark index, virtually all investors will find themselves licking wounds when the dream dies. A portfolio diversified across many funds offers little protection if all the funds have positions in the same key names. If the company has become a true global champion there is even a good chance it turns up in the holdings of international funds that investors bought seeking diversification through foreign equities.

Passive investment vehicles such as index mutual funds or ETFs may be especially dangerous in concentrated markets because they often are just tracking the index, even into dangerously concentrated territory. An actively-managed fund can provide an investment manager with more flexibility to mitigate the risk of over-concentration.

> The **fallout** can extend to all **Canadians**, whether they **know it or not**, and whether they consider themselves **investors or not**.

According to the National Post, in the first quarter of 2015, as Valeant Pharmaceutical's market cap closed in on Royal Bank and approached top dog status, Valeant was the third largest equity holding of the Canada Pension Plan Investment Board, the fund charged with providing retirement, disability and death benefits to almost all individuals in Canada.

What can you do?

If the CPP can be caught up in the hype, what hope is there for the rest of us?

The first step is to have a clear, well-defined investment strategy as part of your financial plan. A long-term plan with reasonable return targets and a defined sell discipline goes a long way to helping you avoid getting swept up in hype and investment fads. Keep an eye open for hype and be extra vigilant when it comes to jumping on bandwagons. A deviation from a well-constructed investment strategy should warrant even more due diligence than your typical investment decisions.

Secondly, recognize the risk of index concentration, particularly in a small market like Canada. If a single stock (or sector for that matter) rises to a dangerous weight in the benchmark, seek diversification elsewhere. ■