A Clash of Titans
Two Theories, Two Very Different Views
in Three Tables

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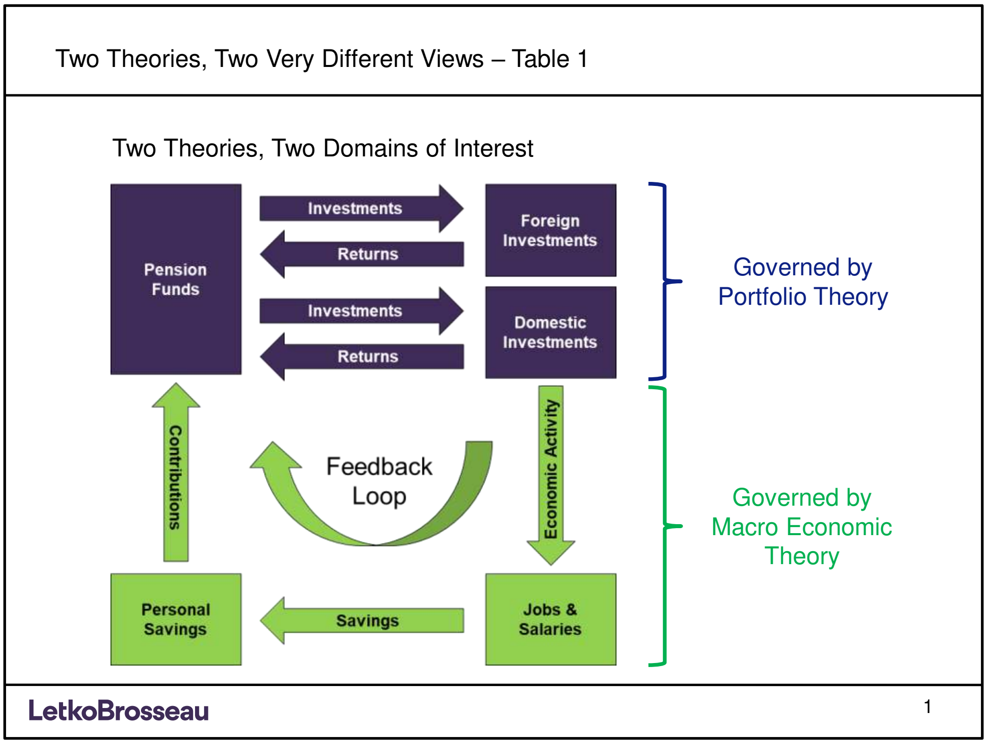
The divestment of Canadian investments by pension funds stems from a very misunderstood source.

- This is not about returns because Canada's returns over the last 25 years have been amongst the best. The TSX has beat the MSCI EAFE by 4% per year and the EM and S&P by close to 1%, yet investments in Canada have declined. Canadian pension fund returns are generally average and might well have been better if all their investments had been made in Canada. Better returns would not have caused Canadian pension funds to invest more in Canada.

- This is not about diversification because you don't need to invest six times more outside the country than inside to diversify your Canada risk. Our largest national pension fund, CPP, has 2% invested in Canadian private and public equities and 55% invested in foreign ones. This is not diversification.

- This is not about Canada's competitiveness. The IMD 2023 World Competitiveness Rankings, based on 336 factors, ranked Canada in the first quartile of most competitive in the World and second amongst the G7, closely behind the US. We always need to make Canada more competitive, get rid of red tape, but even if we did this, we would still have the same problem, because we are already amongst the most competitive.

– This is about a very fundamental problem that we need to address: we have two well established fundamental theories that are giving diametrically different answers.



There is a macro-economic feedback loop at work in the economy that cannot be ignored.

From the Pension Manager's perspective there is little difference between a domestic and foreign investment. There is a big difference however between a foreign and domestic investment when it comes to the economy.

Here we present two simple cases. In case 1 a Canadian invests $100 abroad. After one year they repatriate the $100 and $10 in profit. Their return is 10%. In case 2 a Canadian invests $100 in a machine that produces $210 of product in the year. The costs are $100 of salaries and $100 of wear on the machine, leaving $10 of profit. Their return is 10%.

In case 1, Canada's GDP rises by $10, the profit. In case 2, GDP in Canada increases by $210, the salaries, the machine, and the profit. From the Portfolio's perspective the two investments produced the same return but from a macro-economic perspective, from a GDP perspective, from a GDP per capita perspective, from the perspective of Canada's ability to save, the domestic investment is by far the better one.

If 10% of the salaries in our example are contributed to the pension fund, the pension fund would grow by $10 of contributions and $10 from investment returns to total $20 compared to the $10 from the foreign investment. But the pension fund manager cannot factor in the $10 rise in contributions, the effect of their investments on the incomes of their members. The aggregate impact is substantial as the example illustrates, but it is diffuse. The impact is outside the ability of standard portfolio theory to factor in.

This is the most difficult part to understand. Canada's pensions are well managed but there is an essential piece missing and only government can contribute it.

Two Theories, Two Very Different Views – Table 2

Two Theories, Two Different Conclusions

	Portfolio Theory	Macro-Economic Theory
Investment in Canada	Low	High
Control of Economy	Foreign Control	Domestic Control
Focus	Risk-adjusted returns, regardless of macro-economic implications	Balanced consideration of both risk-adjusted returns and domestic development

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A – Portfolio theory says that Canada is 3% of the world market, and a properly diversified portfolio should have about that amount invested in Canada, anything more is an overweight.

A corollary is that you leave foreigners to have control of your economy. You care only about risks and returns.

B – Macroeconomics theory says that investing in your own economy increases productivity, innovation, jobs, incomes, and standards of living. Not doing so has the reverse effect. The more you invest in yourself the greater your income and wealth.

It also encourages keeping control of your economy to generate more home breed innovation, research & development, more productivity, and more retention of the benefits of the country's development.

You care about investment risks and returns but also all the knock-on effects.

- Both theories are giving completely opposite results: one says to invest little in your own market and have a high degree of foreign ownership. The other says invest the most you can in your own development and retain ownership of your companies and the benefits that ensue.

- This is the fundamental conflict. So, what do you do? A cost benefit analysis could be useful.

Two Theories, Two Very Different Views – Table 3

Two Theories, Two Different Costs and Benefits

	Portfolio Theory	Macro-Economic Theory
For each $5.00 investment	±$0.05 annually per 1% return	±$1.00 annual GDP

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- Going against portfolio theory, your risk is that returns will suffer. Although there is no historical reason to support this because returns in Canada have been amongst the best in the world, a 1% return hit would cost $0.05 for each $5.00 invested.

- Going against macro-economic theory, your risk is that the economy will suffer. A recent study of OMERS' impact on Ontario's economy intimated that every $5 investment added $1 to Ontario's annual GDP. Sending this $5 to the US or China, increases their GDP, their jobs, their incomes, keeping it here increases Canada's.

- A March 2024 presentation by Carolyn Rogers, a deputy governor of the Bank of Canada, talked of an emergency, of the need to need to break the glass to fix our productivity problems. Pension managers have said, with very little factual support, that returns would suffer if they were forced to invest in Canada.

- So, there will be a lot of discussion of what the costs and benefits are, of what the various parties' equities are, of what kind of changes are needed to factor in the macro-economic effects that have been completely ignored to date.

- Once the portfolio and macro-economic issues are resolved and decided upon, we then need to leave the economic agents do their work in the most flexible way possible. This is not about incentivizing or tweaking this or that sector. It is the whole ecosystem that needs to be dealt with.