Why it’s a Bad Idea to Invest in the TSX Index

Description

The **S&P/TSX Composite Index** (TSX:^OSTPX), or TSX index for short, covers about 95% of the Canadian equities market. On initial thought, the index may seem diversified because of that.

However, the devil is in the details. The problem is the TSX index is concentrated in specific sectors, which actually makes it not so diversified and potentially a bad idea to invest in.

The TSX index is not very diversified

Currently, the TSX index’s top four sectors are financials (nearly 36% of its weighting), energy (more than 18%), materials (11%), and industrials (nearly 10%).

It has about 5% or less weighting in each of the remaining sectors, including consumer discretionary, communication services, utilities, consumer staples, information technology (IT), and health care.

That doesn’t seem very balanced, does it?

Financials is a key sector in Canada. So, not surprisingly, four of the top 10 holdings in the TSX index are the largest Canadian banks: **Royal Bank of Canada**, **Toronto-Dominion Bank**, **Bank of Nova Scotia**, and **Bank of Montreal**.

Many Canadian investors already own Canada’s big banks, which would make them double exposed to the banks if they also hold the TSX index.

What the TSX index lacks

The TSX index lacks in the relatively stable sectors of consumer discretionary, communication services, utilities, and consumer staples, which conservative or retired investors might want a higher concentration in.

The index is also poorly exposed to the IT sector with only a puny 3.18% "concentration" in it. In my opinion, this sector is a growth area that investors should highly consider getting a meaningful exposure to. They can gain exposure through a technology ETF or buying specific tech stocks, such as **Microsoft**, **OpenText**, or **Shopify** when they seem to be relatively cheap.

Think about the high-growth areas of artificial intelligence, augmented reality, cyber security, the internet of things, automation, etc. They are all a part of IT.

Investor takeaway

The TSX index is not diversified. It's highly concentrated in the financials and energy sectors and lacks in the consumer discretionary, communication services, utilities, consumer staples, IT, and health care sectors. However, the index is a good gauge of the Canadian market.

TSX index's top holdings, including **Enbridge**, **Canadian National Railway**, **Suncor Energy**, **TransCanada**, **Brookfield Asset Management**, and **BCE** are a great place to source for stock ideas, but investors should only consider buying them when they trade at good valuations.

Investors should plan for the ideal allocation for each sector in their portfolios and decide which ETFs or stocks make the best fit for the allocation.

Of course, the sector allocation and what goes in it will likely change over time because the economic and business environments are always changing.

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