QV Update

QV Investors

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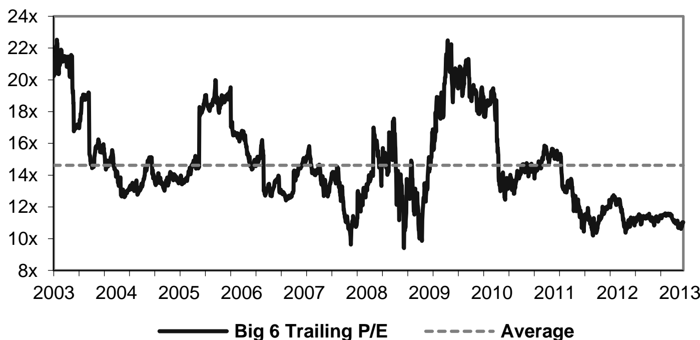
Big Bets on Canadian Banks

In reporting our quarterly performance to clients we are often asked where we see opportunities in the market. With the materials sector off 22.9% year-to-date our screens find plenty of value in this space, but our fundamental analysis finds little quality. Another area of the market where we see opportunity is in the financials sector, which includes both insurers and banks. The sector is up just 0.8% year-to-date, compared to the S&P/TSX Composite Index of 1.2%.

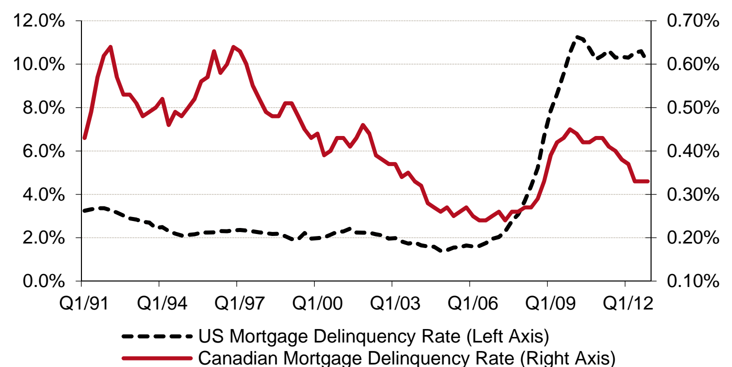
Canadian banks have been in the media spotlight this past week. Not because they trade at an attractive 10.5 times earnings or generate healthy return on equity north of 16%. Rather, the dark cloud that has formed from low interest rates and housing market uncertainty has become gloomier with hedge fund managers, Friedberg Mercantile Group Ltd. and Hyphen Partners LP, taking big bets that Canadian banks will collapse. Their investment thesis is centered on a fragile Canadian housing market. The trigger for a crash, as suggested by one US manager, will be an emerging market crisis that will flow through to the resource-driven Canadian economy. While we maintain a cautious outlook considering the softness of economic growth, and cannot argue against the possibility of a crisis, we believe the Canadian banking industry has measures in place to retain its strength.

Firstly, the valuations on Canada's Big 6 banks (Royal, TD, CIBC, Scotia, Bank of Montreal, and National) are near historical lows including those of the '08-'09 crisis, as shown in the P/E chart below. While the Big 6 offer very attractive dividend yields of around 4% or better, persistent low rates and slower loan growth are preventing bank multiples from expanding like those of utilities and telecommunications businesses. However, earnings at the Big 6 are the highest in the history of these firms, which attests to their ability to adapt to low rates and tighter lending practices.



Source: Capital IQ

Secondly, the strength of a bank can be measured in several ways. In terms of capital, or the ability to support their loan books, the Big 6 in aggregate exceed the 8% minimum capital ratio set by regulators. While the argument has been made that the risk weight applied to Canadian uninsured mortgages is lower at 10% than the 20% in Europe or 35% in the US, analysis done by Canaccord Genuity suggests that doubling Canadian risk weights would not result in a violation of the regulatory minimum capital ratio. In terms of credit quality, stricter lending guidelines have improved the risk profile of the average borrower on a bank's loan book. While we should be concerned that Canadian household debt as a proportion of income is now higher than that of the US, we should be aware that Canada has historically had more conservative lending practices. This can be observed in the significantly lower level of Canadian mortgage delinquencies (chart below). The new mortgage rules have reduced loan volumes, but have led to high-grading of bank loan books. With improved credit quality, lower loss provisions are required, which lead to improved bank earnings.



Source: Cdn Bankers Association, Federal Reserve, Cormark Securities

The stock prices of the Canadian banks were hit hard during the financial crisis. However, these resilient businesses came out of the crisis without government bailout, and are stronger in credit, and better capitalized today. Additional confidence in the Canadian banks is shown by the regulators, who have allowed the Big 6 to continue raising dividends, buying back stock, and making acquisitions.

Strong financial measures and attractive valuations are why we see opportunity to own the best Canadian financial institutions. These businesses provide stable dividends and offer excellent compounding rates to our portfolios. In the Canadian Equity and Balanced mandates we currently hold positions in Bank of Nova Scotia, National Bank, and TD Bank at average to above-average weights.

Let me stress, we believe measures are in place to protect the Canadian banking system against global shocks. We do not believe our banks will avoid the impact of a global economic crisis. As a result, our 6% security level and 25% sector level constraints prevent us from over indulging in this area of the market where great value is available, but also where uncertainty remains high.