Papau Armstrong Schmidt
Financial Group

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# Canadian Banks in Focus

The U.S. Presidential campaign has been dominating the headlines lately. Many Canadians are closely following the controversy and debates. It sometimes seems like we are more engaged in this U.S. campaign than we are in our own domestic politics. Since the campaign is already being covered from all angles, we are going to steer clear of it in this third quarter (Q3) edition of our Newsletter and focus on a topic that will be very relevant to many clients – the Canadian banks.

Since the formation of the Papau Armstrong Schmidt Financial Group in October of 2014, we have not devoted any significant space in our newsletters to the Canadian banks. Most of this Q3 edition will focus on that topic, especially since the federal government has recently made an announcement that affects their business.

## Introduction to Canadian Banks

Many clients are familiar with the business models of Canadian banks. Canadian personal and commercial banking still represents a large percentage of their earnings, but they are best viewed as diversified financial services companies. Earnings also come from capital markets activities, wealth management, insurance and foreign banking.

Canadian banking remains an oligopoly – a state of limited competition – where a large portion of the market is shared by a small number of domestic banks. There are foreign banks that are authorized to do business in Canada, but they are subject to some restrictions. The structure of the industry contributes to higher profit margins relative to banks in other countries. The five largest Canadian banks are Royal Bank of Canada (TSX:RY), Toronto-Dominion Bank (TSX:TD), Bank of Nova Scotia (TSX:BNS), Bank of Montreal (TSX:BMO) and Canadian Imperial Bank of Commerce (TSX:CM), which owns CIBC Wood Gundy Inc.[1]

## Historical Investment Performance

Historically, Canadian banks have been good investments for our clients and for many Canadian investors generally. In many cases, we have clients who have held various individual Canadian bank stocks for 20-30 years. The performance has been good, and their main concern now is how to deal with any future tax consequences of a large unrealized capital gain. In addition to capital gains, the Canadian banks have consistently paid dividends. CIBC World Markets recently calculated that a group of five large Canadian banks have increased their dividends by an average of 8.7% per year over the past 30 years, an excellent track record.[2]

## Recent Developments

For several years we have had concerns about Canadian household debt and the risk it poses to financial stability. We have seen large increases in Toronto and Vancouver home prices and a continued willingness among home buyers to take on uncomfortably large mortgage debts. The International Monetary Fund recently noted that Canada, along with Singapore and Australia, has experienced the fastest-growing private sector debt since the global financial crisis.[3] The federal government has now become concerned enough to take action and is proposing that banks share some of the risk of insured mortgages.

In Canada, home buyers with down payments of less than 20% of the cost of the home are typically required to insure the mortgage against default. The federal government-backed Canada Mortgage and Housing Corporation (CMHC) is the primary provider of the insurance. Taxpayers ultimately stand behind the CMHC if it runs into difficulties. This system has dramatically expanded access to mortgage credit in Canada:

> "Lenders can offer credit to Canadian homebuyers, on generous terms while collecting impressive profits, while taking very little risk and avoiding future losses. This system is unique in the world. Basically it transforms high-ratio mortgages into Triple-A credit debt, equivalent to the safest government bonds. If lenders had been required to carry all risks associated with default on these loans, the amount of mortgage credit outstanding would be a modest fraction of what it is today."[4]

As of Q3, 2016, the big 6 banks (including National Bank of Canada (TSX:NA)) held approximately $1.2 trillion of residential mortgages, split roughly evenly between insured and uninsured.[5] Insured mortgage lending has been a profitable business with minimal risk. However, despite the lobbying efforts that are sure to come from the banks, the future of insured mortgage lending will look different from the recent past:

> "Risk sharing will most likely involve lenders paying a deductible if a loan sours, similar to what drivers pay in the event of a car crash, according to people familiar with the government plans. Other risk-sharing measures that have been reviewed by the finance department include banks paying a fee to insurers to manage the loss, or taking a portion of the loss."[6]

These measures are likely to be introduced in a very gradual manner.[7] Interestingly, shares of the Canadian banks were affected minimally by the federal government's announcement, likely due to their strong market position and diversified income streams. Investors will need to wait for more information about the risk sharing proposals to determine if the impact on Canadian banks is materially negative.

## Outlook for Canadian Banks

Canadian banks have been solid investments for many years, providing both capital growth and dividends. From our perspective, they continue to qualify as high-quality companies that appear to be worth owning. Despite their positive characteristics, it is important to resist becoming complacent and openly acknowledge their challenges. As we have mentioned in past newsletters, the debt to income ratio of Canadian households is now hovering around record highs. Canadians' willingness to take on high levels of personal debt over the past decade has contributed to earnings growth for Canadian banks.

We are also seeing all levels of government acknowledge that elevated house prices in cities like Vancouver and Toronto are problematic. For example, in British Columbia, the Provincial government introduced a 15% tax on foreign buyers in the Metro Vancouver area. Other regulatory changes are happening, including risk sharing on insured mortgages. The outlook for Canadian banks to significantly increase lending to Canadian households is therefore weakening. Also, growth in the overall Canadian economy is generally slow, reducing the opportunities for banks to grow domestically. They will likely continue to seek growth outside of Canada, both through investing in existing businesses and through acquisitions, which can lead to added risk. Overall, we believe that the earnings and dividend growth for Canadian banks over the next 5-10 years will not be as high as in the recent past.

Weighting in Client Portfolios

Our clients have varying levels of ownership in the largest Canadian banks. In some cases, clients have held bank shares for 20-30 years, resulting in very large capital gains. While this is a good outcome, it is now requiring us to exercise caution when reallocating portfolios to suit current conditions, due to concerns about triggering large capital gains for tax purposes.

In our discretionary model portfolios, we have positions in Toronto-Dominion Bank and Bank of Nova Scotia. The Toronto-Dominion Bank position was a recent addition to our Total Return Portfolio. We paid $58.24 per share on September 22. Toronto Dominion Bank is a good example of successful international expansion, as U.S. personal and commercial banking now represents approximately 30% of its earnings.[8] Bank of Nova Scotia has been a multi-year holding in our High Yield Portfolio. It has also been successful in expanding internationally into Latin American, the Caribbean and parts of Asia. The downside to the Bank of Nova Scotia's expansion strategy is that some of its chosen countries are less stable economically than Canada or the United States.

Generally speaking, in the average client portfolio we maintain exposure to the Canadian banks, but tend to be underweight relative to their weightings in the S&P/TSX Composite Index where the bank-dominated financial sector makes up around 1/3 of the Index.

Additional Q3 Portfolio Highlights

In addition to our purchase of Toronto-Dominion Bank in the Total Return Portfolio, there are a couple other purchases that we would like to highlight.

Under Armour Inc. (NYSE:UA) is an athletic apparel maker that has emerged over the last decade as an aggressive competitor to global brands Nike Inc. (NYSE:NKE) and Adidas AG. In a March 8, 2016 article on our website titled "Under Armour – Brand Value Keeps Increasing," we covered Under Armour in depth. We noted that the company's brand is strong and getting stronger, as many active people, both male and female, love the company's products. The company has done an excellent job of linking the brand to high profile athletes, and the brand is popular among athletes participating in numerous sports. Despite the rich valuation of the shares, we recently added a 2.0% weighting in Under Armour shares in the Total Return Portfolio. We paid US$39.63 per share on September 22. The main opportunity is that the company could continue to grow its sales and earnings globally over the next decade in a consistent fashion, potentially moving towards the level of sales and profits enjoyed by Nike and Adidas today.

On September 8, we purchased a 2.5% weighting in Schlumberger Ltd. (NYSE:SLB) in the Total Return Portfolio at a price of US$78.55 per share. Schlumberger is a globally diversified technological leader in the energy services industry with good long-term growth prospects and high profitability. Historically Schlumberger shares rarely trade at a depressed valuation, and they are not exceptionally cheap today. However, we believe the quality of the business and its long-term growth prospects make the shares worth accumulating.

Also, we are continuing to build moderate-sized positions in Canadian real estate investment trusts (REITs) in all three model portfolios – the Total Return, High Yield and Balanced. We covered REITs in depth in our Q1 2016 Newsletter, which is archived on our website.

***Conclusion***

We believe that our three discretionary portfolios (Total Return, High Yield and Balanced) are well-positioned for the remainder of the year. While there may not be significant changes coming to client portfolios before the end of 2016, we are always watching for opportunities to generate higher long-term returns.

Thank you for reading our Q3 Newsletter. We look forward to communicating with you and answering any questions you may have about our discretionary model portfolios, your personal circumstances, or other topics of interest. As always, we thank you for your business.

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## APPENDIX "A"

## DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[1] Please note the disclaimers relating to these five Canadian banks below.
[2] CIBC World Markets Bank Valuation Quarterly dated October 12, 2016 (p. 17)
[3] http://www.macleans.ca/economy/economicanalysis/change-and-pain-are-headed-for-canadas-housing-market/
[4] http://www.macleans.ca/economy/economicanalysis/change-and-pain-are-headed-for-canadas-housing-market/
[5] Hamilton Capital, Canadian Banks: Housing Correction Concerns Increasing Regulatory Risk, October 12, 2016
[6] http://www.bloomberg.com/news/articles/2016-10-11/canada-banks-insurers-rally-opposition-to-new-housing-rules
[7] http://business.financialpost.com/personal-finance/mortgages-real-estate/canadas-440-billion-mortgage-backed-securities-market-may-cool-on-new-rules
[8] CIBC World Markets Bank Valuation Quarterly dated October 12, 2016 (p. 11)

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David Papau, Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. They and their clients may own securities mentioned in this column. Their views do not necessarily reflect those of CIBC World Markets Inc.

If you are currently a CIBC Wood Gundy client, please contact your Investment Advisor.

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