Leith Wheeler
INVESTMENT COUNSEL LTD.

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INVESTMENT OUTLOOK

We're not betting against the Canadian Banks

In the last few years, the Canadian chartered banks have not been the consensus investment they once were. The doomsayers have been predicting an end to their magical run, with the bursting of the Canadian housing bubble and the slowdown of the over-indebted consumer impacting the banks' large mortgage lending businesses. We look through these concerns, however, and continue to own a meaningful part of our Canadian equity portfolio in the Canadian Banks; a decision that has paid off for clients. The banks have outperformed the TSX Composite Index in 10 of the past 12 years.

In our view, there is a lot to like about the banks as long term investments. As Warren Buffett instructs, look for businesses with "strong economic moats". In other words, companies with dominant positions whose franchises are hard to duplicate. The Canadian banks epitomize this. The Canadian banking industry is highly concentrated, with the top six banks dominating virtually every category in which they participate, effectively making it an oligopoly. Through their broad national branch networks and strong brands, the Canadian banks control the distribution channels and make it very difficult for new entrants to pose a meaningful threat. Replicating the banks' national networks would be enormously difficult and expensive, not to mention the challenges inherent in overcoming the banks' level of trust and brand loyalty with consumers.

Not only are the banks hard to compete with, but they are hugely profitable too. The ROE (Return on Equity) on the banks has averaged an impressive 17.5 % over the last 10 years. Equity is defined as what the shareholders have invested in a respective business, so ROE is a measure of how well management is doing with the shareholder's money. Each year in the annual report of Berkshire Hathaway, Buffett stresses the importance of

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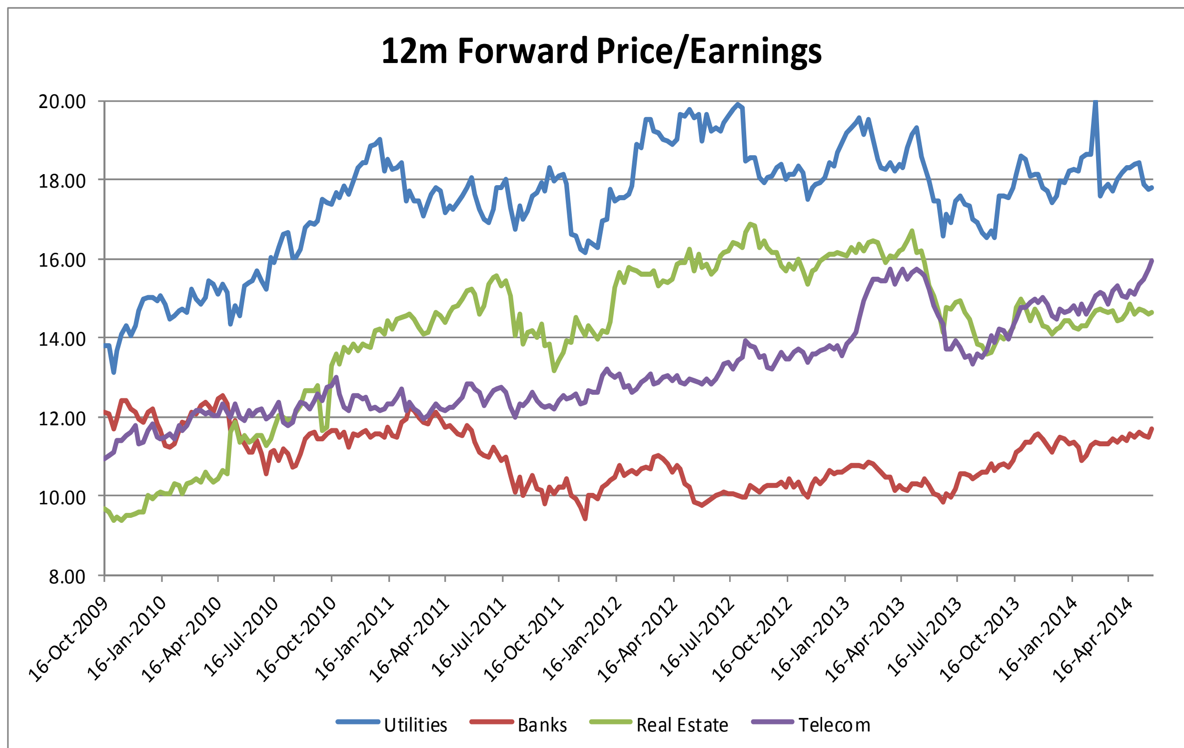
buying companies with high ROE. He looks for an ROE of 15% or higher. In addition, the banks generate a tremendous amount of free cash flow and have a long history of distributing a large portion of this to their shareholders in the form of rising dividend streams; another quality we love!

The Canadian banking sector is stable, sophisticated, well-regulated, highly competitive and considered to be one of the best in the world. Globally, it was the banking system that came through the financial crisis of 2008/09 the strongest, thanks to OFSI's (the Office of the Superintendent of Financial Institutions) well-defined guidelines and safeguards.

The banks now have very diversified streams of earnings that include a very powerful retail platform, commercial banking, wealth management, investment banking, corporate lending and trading businesses. For years now, the banks have also been pursuing strategies beyond our Canadian border in key foreign markets that have the potential for further growth and higher profits. The opportunity is to export the Canadian bank brand and best practices to other markets. One of our largest holdings is in Scotiabank, which has made some shrewd acquisitions in South America in the last decade. As a result, Scotiabank now generates one quarter of its earnings from its international banking operation and is well-positioned to benefit from the continued growth in the economies of countries such as Mexico, Chile, Peru and Colombia. With Scotiabank's recent sale of a portion of its holding in CI Financial, the bank will have more resources to expand its global footprint. We expect to see future South American acquisitions that should further enhance the bank's earnings outlook.

Despite being great businesses, the Canadian banks are not expensive. Investor appetite for yield in recent years has driven up the value of lower volatility, dividend paying stocks to, what we feel, are expensive levels. This would include the utility, REIT and telecom stocks. The banks, however, have been left behind in this crowded "yield trade" (see chart below).

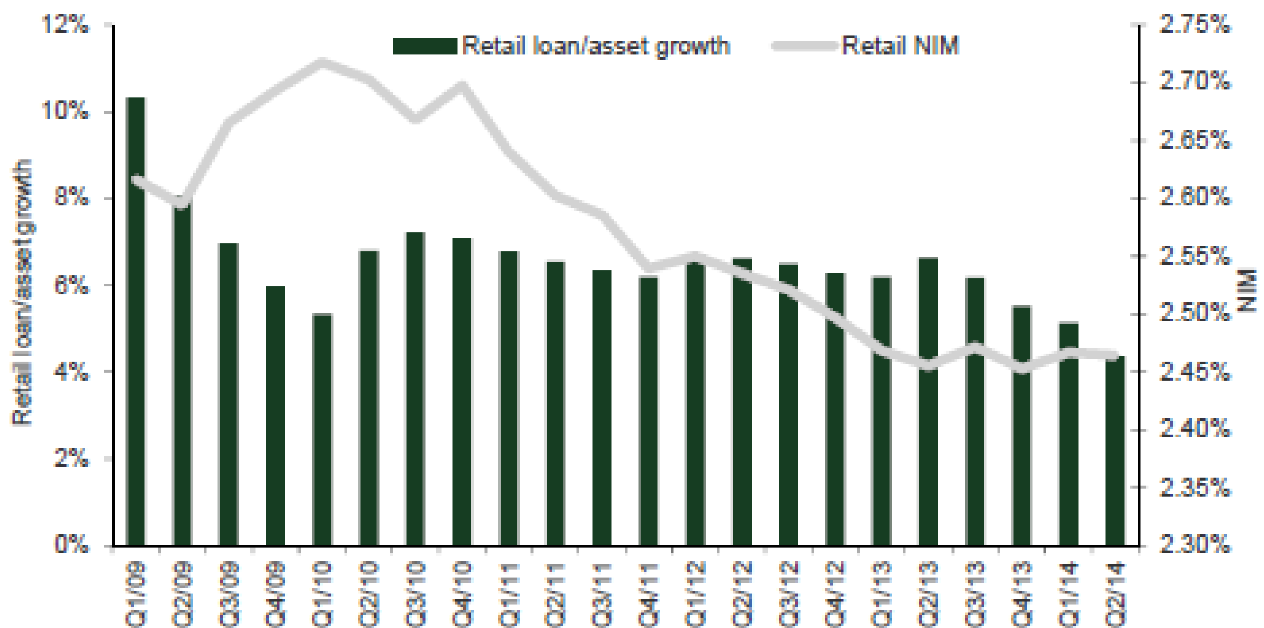


Source: FactSet

*Real Estate is based on Price to Adjusted Funds From Operations (Not Price to Earnings)

The chart shows the 12 month forward Price/Earnings multiple for three sectors in the Canadian market: the utility, telecom, REIT and bank sectors. The forward P/E uses consensus earnings estimates rather than trailing earnings. As the chart illustrates, the chartered banks have actually seen their valuations drop since 2009. Why is this? Mainly due to concerns that an over-valued real estate market and an overextended consumer could result in a U.S. style real estate correction. It is important to note, however, that there are some major differences between mortgage lending practices in Canada and those in the U.S. An important one is that OFSI prevents the Canadian chartered banks from issuing a residential mortgage with a loan to value ratio greater than 80% without insuring the balance with a third party mortgage insurance company, like the government-owned CHMC. The average loan to value ratio in the Canadian banks' uninsured residential mortgage portfolios is approximately 55-60%. This provides the banks with a significant cushion should housing prices drop. In other words, home prices would have to drop substantially before a bank would be hit with a loss.

In spite of the cloud over them, the banks continue to generate impressive profits and remain undervalued. We expect loan growth to be around 4-5% per year going forward (see chart). Net interest margins (NIM), which is the difference between what the banks pay depositors and the interest income generated by their assets and loans, has been dropping steadily since 2008, but should stabilize this year. The bank's NIM will be helped by rising Canada bond yields and, materially, by a rising Prime Rate as the economy continues to recover. A rising NIM in 2015 and 2016 will be very powerful to earnings growth as revenues rise faster than expenses.



Source: Company reports, TD Securities Inc.

A bright spot for the banks since the financial crisis has been the shrinking number of bad loans on their books. As a result, we have seen their provisions for loan losses, the capital set aside as a safety buffer to absorb any losses from non-performing loans, plummet. This drop is good news, but some argue that loan losses can only get worse from here. We agree and are forecasting loan losses to rise, along with loan growth, over the next three years.

Predicting where Canadian real estate is headed is a difficult game, but we are not anticipating a U.S. style crash. In our view, the Canadian banks offer good value and we continue to believe they are an important part of your portfolio. As a group, they should provide double digit returns over the next three years.

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