The Wrap Up

Wild Horses Couldn`t Drag Me Away, From Banks

Lucky were we on our timing! Over the last two weeks, we discussed the divergence between the Canadian and American economies and this week we were treated to economic data all but confirming this reality. Third quarter GDP came in at 5.2% in the United States and at -1.1% in Canada. Today, we want to look at and tie into this divergent theme by analyzing the most popular holding we continue to see today: Canadian banks.

My 15 years in the industry has yielded two truths: the market is a wild horse that can drag you away and Canadian banks are as likely to pay dividends as the sun will rise in the morning. The Canadian banking industry is often reduced to the term 'the big five' (sometimes the 'big six' if you wish to include the smaller and more Quebec focused National Bank), encompassing RBC, TD, Scotiabank, CIBC and of course, BMO. There are other smaller banks, foreign banks and credit unions that exist within the country, however the 'big five' account for 85% of the country's banking system (93% when you expand to the 'big six') compared to approximately 50% for America's five largest banks. This industry concentration has allowed for several developments. We have highly developed financial institutions with tentacles in every domain of finance (from banking to asset management to market making), we have a stable banking environment, high degrees of confidence in the industry and (as a plus for investors), consistent profitability.

Over the last decade, investing in Canadian banks has proven to be a very profitable trade. Without accounting for dividends, a 10 year holding period in each of the banks would have yielded an annualized return of 7.5% for RBC, 7.3% for TD, 5.3% for BMO, 2.6% for CIBC and -0.4% for Scotia. When you include the average dividend yield over that same period, you can add an additional 3.7-4% per year, depending on the bank in question. Excluding the Scotia trade, holding a Canadian bank over the last decade returned you an average of 6.5% to 11.2% per year on a fairly consistent basis. The banks have also grown to become much more than just Canadian financial conglomerates; they have sizable operations outside their domestic markets as well. RBC, TD and BMO now derive more than 35% of their revenues from

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the United States and Scotiabank has more than 35% coming from Central and South America.

A bet on Canadian banks offers a unique blend of domestic protection, foreign diversification, high dividend income and moderately steady growth. It is no wonder that we see individuals with 40, 50, sometimes even 60% portfolio exposure to just Canadian banks. Something that we've concluded and articulated in our weekly recaps is that the markets and the economies of today, are not the same ones of 2010-2020 and investment strategies that do not account for that change are likely to underperform investor expectations. Since the beginning of this decade, the banks were averaging, on an annual basis, 2% less than they have compared to their 10 year average. In 2023, the equal weight banks index is slightly negative even when including dividends compared to a 4.3% return for the broader TSX index (and close to 19% for the S&P 500). When you dramatically overweight a sector and it underperforms by 5 or 10%, you create a performance drag that will likely needs years of outperformance just to balance itself out.

Looking forward there is still a lot of uncertainty that will weigh on bank shares, namely, the elevated mortgage debt levels and real estate prices that are plaguing Canadian residents and the growing risk of office and (some) retail real estate. The previous decade benefitted from low real estate prices and low debt levels; at this point we simply cannot expect to see that same level of loan growth or asset price growth without some greater consequence. All the banks have reported their earnings this week and what has stood out is the amount of money that the banks have put aside for loan loss provisions on their Canadian banking operations. Keep in mind that Americans roll with 30 year mortgages while Canadians have 5 year interest rate terms; rates have gone up dramatically in the last couple of years and have had a greater impact on the Canadian economy than on the US one. We do not need to think of a real estate meltdown like what was experienced in 2008, but just imagine what a few years of slower profit growth and higher loan write-offs would do for banking shares. What distinguishes Canadian banks today, from American banks in 2008, is that Canada has stricter lending standards and the post financial crisis environment has also asked more of financial institutions in order to be prepared for such volatile events.

The Canadian banks are well capitalized, are very conservative in their nature and are still relatively safe companies to have exposure to in your portfolio. It is to little fault of their own that their businesses are experiencing challenges; this is really a macroeconomic problem that has built up over a fifteen year period. With that, we want to say that we continue to invest in Canadian banks, but not all five of them and definitely nowhere near the 40 or 50% exposures that we have seen. We are entirely aware of the enticing valuations that the banks are currently trading at and we find the long term stories for our holdings to continue to be compelling. That being said, if there was any reason to be market weight or even underweight a sector, the current macro reality is as a good a reason as we can find. For our clients, you know what we own, you should know why we own it and if you aren't sure, please reach out to Leon or myself and we would be happy to confirm our viewpoints on our Canadian banking exposures. For everyone out there who manages their own portfolio or works with another financial professional, ask yourself if your expectations towards Canadian banks are realistic. Ask yourself if your exposure towards Canadian banks is justified. Most importantly, ask yourself if your allocation towards Canadian banks is going to allow your portfolio to generate the returns you need.

One of the themes that we've articulated over the last 18 months is the need to adapt our portfolios to an uncertain environment. Uncertainty is less about bad performance as much as its about unpredictable performance; we invest in order to achieve a goal. Whether you are sensitive to risk or depend on your investment portfolio to support your way of living, you should seek to narrow the range of outcomes and have more consistency in your returns. The next time you are rebalancing your holdings, take a second look at your Canadian banking exposure and remember what you read today.

Healthy distraction

‘Tis the season for holiday parties! The Laval Private Wealth team had ours just last night. We seldom speak about our management team but we wanted to take a moment to thank them. Michel, Phil and Marwah, thank you for everything that you’ve done this past year. Our clients do not know how many exceptions are needed or miracles are manifested on a daily basis and its largely because of the work that you do!

For everyone that will be gathering this time of year, we know the fun in having a drink or two. Whether it’s the perfect wine paring to the meal or a rare scotch that someone was kind enough to share, having a drink at a social gathering is an activity enjoyed by many. What’s most important is that we are careful and aware when it comes to getting home afterwards.

In the era of Uber, it has become increasingly easy to arrange for an alternative way home. This holiday season, please be mindful that the road is a shared space where drivers are exposed to the decision making of others. Local organization *Opération Nez Rouge* also has a mobile application; if you want to let loose at your holiday party, maybe download the app before starting the festivities.