# Canadian Banks Might Be Too Risky for Widows and Orphans

## Description

Canadian banks have traditionally been viewed as ideal stocks for investors who have a lower tolerance for risk. Historically, these banks have paid out hefty and growing dividends, while also operating in a safer environment compared with their American counterparts. In general, Canadian bank stocks have allowed investors to sleep well at night.

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This may no longer be the case, however. There is currently a debate as to whether Canada is experiencing a housing bubble. If there is a bubble and it does pop, then Canadian banks would most likely see their share prices decline considerably. In light of the possibility of a crisis in the near term, are Canadian banks still a good option for conservative investors?

**The strongest banks in the world?**
I made the positive case for Canadian banks almost two years ago. Back then, big American banks like **Citigroup** and **Bank of America** had seen their share prices crater as investors appeared to lose trust in all banks indiscriminately. To me, it seemed like Canadian banks might offer investors attractive yields without all of the stress and anxiety associated with that sector.

Since that time, the five Canadian banks have performed reasonably well, as the following chart indicates:

| Company | Mkt Cap | Div Yield | Total Return since Oct '11 |
|---|---|---|---|
| **Royal Bank** (TSX:RY) | $88.8B | 4.0% | 41.1% |
| **Scotia** (TSX:BNS) | $68.2B | 4.1% | 20.5% |
| **TD Bank** (TSX:TD) | $74.4B | 3.9% | 18.5% |

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|---|---|---|---|
| **BMO** (TSX:BMO) | $39.9B | 4.7% | 15.3% |
| **CIBC** (TSX:CM) | $31.2B | 4.7% | 13.4% |

*Source: Capital IQ*

All five banks delivered healthy total returns for the period. Combined, the group of five provided an average return of 21.8%, which compares favorably with a return of 7.1% for the **S&P/TSX Composite** over the same period. For an additional comparison, shares of Bank of America and Citigroup were up 106% and 67% respectively, over the same time frame, though they both experienced considerable volatility.

In addition to outperforming the broader S&P/TSX Composite Index, the Canadian banks offered investors a nice dividend yield without too much volatility. The stability of these banks seems to have been further underlined recently by the news that four of them are now ranked in the top 10 of the strongest banks in the world. According to Bloomberg Markets, CIBC, RBC, Scotia, and TD were ranked 3rd, 4th, 7th, and 8th, respectively out of a list of 78 global banks that made the final cut.

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**Crack Shack or mansion?**
Despite the apparent stability of Canadian banks, the hypothesis that they carry considerably less risk than other global banks might not be tenable any longer. There is a widespread debate at the moment about the existence of a Canadian housing bubble, and the negative scenario could have serious consequences for the country's banks.

The evidence for a bubble appears compelling at first glance. Housing prices have more than doubled since 2000, and the ratio of house prices to income is now 30% above the historical average, according to *The Economist*. Less scientifically, the fact that it has become difficult to tell the difference between a "crack shack" or a "mansion" in Vancouver is an ominous sign.

Over the past year, Canada's housing market has begun to cool, however. Some observers see this as the bubble starting to burst, while others characterize the cooling as the early stages of a "soft landing." According to a recent Royal Bank of Canada report, housing prices in Canada have declined somewhat since their peak in June 2012, but have steadied in 2013. In conclusion, the report sees Canada's "overall housing market still facing somewhat higher-than-usual stress."

**What does this mean for the banks?**
If Canada is in the midst of a bursting housing bubble, then that might have serious consequences for its banks. According to the *Financial Times*, residential mortgages account for approximately 25% of the total assets of banks in Canada. Given that fact, there could be serious consequences for the balance sheets of Canadian banks if the housing market saw a significant correction. Morningstar pessimistically declared that it was "not convinced that equity built into residential mortgages is enough to fully protect the banks or Canadian taxpayers."

Another pessimist is the hedge fund manager Steve Eisman, who was prominently featured in Michael Lewis' book *The Big Short*. Speaking at the Ira Sohn Investment Conference in early May, Eisman said that if a housing slowdown comes to Canada, the Canadian banks will really get hit. Eisman, of course, isn't the only hedge fund manager who feels this way — recently, we've learned of several of them who are betting against Canadian banks.

Some bank analysts are not nearly as pessimistic. For example, Scotia analyst Kevin Choquette, as reported in *The Globe and Mail*, said that even a housing drop of 35% would be "manageable" for Canadian banks. And just last week, Toronto-Dominion CEO Ed Clark said that he felt the government policies in response to the housing market were having a positive impact. In TD's earnings call, Clark declared that "Canadians do not need to worry" and that he doesn't view recent price softening as a "prelude to a major correction."

**Buy, sell, or hold Canadian banks?**
So what does all of this mean for investors?

I recently asked Canadian-based Motley Fool advisor Jim Gillies for his thoughts on Canadian banks in the current environment. In a nutshell, he believes that they "won't kill you, but that they won't make you rich, either."

Jim added that he doesn't think Canada is experiencing a housing bubble at the moment. He does believe, however, that investors need to be more aware of risk with Canadian banks right now. He believes they'll ultimately go up in value over the next 10 years, while continuing to deliver their generous dividend yields.

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My own view is slightly more bearish than Jim's. I agree that Canadian banks remain a solid way for long-term investors to gain exposure to the banking sector. But I also feel that these banks carry far more near-term risk than usual. And that risk might be more than many conservative investors are willing to take.

In short, this seems like a pitch I don't want to swing at. And the great thing about investing is that I won't get punished for not doing so.

Just investing in the S&P/TSX Composite Index might not be the best solution either, however. Despite having posted a great return over the past 10 years, it's structurally flawed. The fact that it's overweight in financial and resource stocks means index investors lack proper diversification.

For a better solution, we have created an exclusive free report detailing "5 Stocks That Should Replace Your Canadian Index Fund," designed as an easy-to-implement strategy for market-beating returns. To download a copy of this FREE report, simply click here right now.

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*This article was created by Fool.com contributor John Reeves.*

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