Which Big Bank Belongs in Your Portfolio?

Description

Will Scotia Bank Outperform in a Declining Market?

Identifying large, established companies with little debt, high return on equity, a track record of earnings growth with limited volatility, and an attractive price-to-earnings ratio is an excellent place to start when compiling a list of stocks that should perform well in a declining market.

However, this type of top-down evaluation, or “screen”, is just the beginning. Investors should also complete a more comprehensive, bottom-up assessment to find the quality stocks that will deliver market-beating returns over the long term.

In this article, we take a closer look at **Scotia Bank** (TSX:BNS)(NYSE:BNS), one of two Canadian banks that passed the above criteria employed to identify 10 quality stocks to beat a declining market. We compare Scotia Bank with the other Canadian “big 5” banks using metrics to assess value, credit risk and profitability. Our goal is to determine whether Scotia Bank is the best candidate of the big 5 to perform well in a declining market, and deliver market-beating returns over the next three to five years.

Let’s begin by understanding the value proposition offered by the broader Canadian banking sector.

As most Canadian investors are agonizingly aware, the **S&P/TSX Index** (TSX:OSPTX) rose just under 10% in 2013, significantly underperforming the 30% increase in the S&P 500 index.

The five largest Canadian banks performed reasonably well in 2013. **The Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) performed the best with a 20% gain for the year, followed by the **Royal Bank of Canada** (TSX:RY)(NYSE:RY) at 18% with Scotia Bank and **Bank of Montreal** (TSX:BMO)(NYSE:BMO) both increasing by 16%. The **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) delivered the weakest performance of the group, offering shareholders a 13% return on their investment in 2013.

As a group, however, there is still much value to be found in the Canadian banking sector. Theaverage P/E ratio for Canada’s big 5 banks is just 12.15, which compares very favorably to the broader S&P/TSX index, which ended 2013 at a much more expensive P/E ratio of 16.20.

Value
Every investor likes quality stocks at attractive prices. To determine which Canadian bank’s stock offers the best value, we compare price-to-earnings and price-to-book ratios.

Scotia Bank’s forward P/E ratio is 10.76. While attractive relative to the broader market, it is on par with the average of 10.49 for the big 5. The lowest P/E ratio belongs to CIBC at 8.80, the smallest of the group with a market capitalization of around $36 billion.

Finally, Scotia Bank has the second best price-to-book ratio of the group at 1.89. The most attractive stock in terms of P/B ratio is the Bank of Montreal at 1.66.

Credit Risk
Bloomberg’s 2013 World’s Strongest Banks analysis reinforces what the Bank of Canada has been telling Canadians almost daily since the 2007/2008 global financial crisis — we have one of the world’s strongest banking sectors.

Four of Canada’s five largest banks made the list. Scotia Bank ranked seventh in the world. Which Canadian bank placed highest? That honor goes to CIBC, the world’s third strongest bank behind only OCBC Bank and Qatar National.

Profitability
Many invest in bank stocks due to their strong, steady and reliable dividend income — all made possible, of course, by exceptional profitability.

Scotia Bank enjoys the strongest profit margin of the group at 32%, just ahead of CIBC at 29%. In general, all five of Canada’s largest banks enjoy healthy profit margins, averaging just over 28%.

A second measure of profitability is return on equity. Scotia Bank’s return on equity is just over 15%, in line with the group’s average. CIBC, once again distinguishes itself, by delivering the strongest return on equity at an impressive 19%.

Foolish bottom line
Scotia Bank is an excellent choice for investors seeking a large company with solid fundamentals that should perform well in a declining market. And with Scotia Bank having lost nearly 4% of its value this year, primarily due to concerns regarding exposure to developing economies, now may be a good entry point for investors.

However, CIBC may offer the largest upside potential for investor striving for market-beating results over the long term. The bank performed best against our criteria of valuation, profitability and credit risk, and would be an excellent addition to a well-diversified portfolio.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:BMO (Bank Of Montreal)
2. TSX:BNS (Bank Of Nova Scotia)
3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:RY (Royal Bank of Canada)
5. TSX:TD (The Toronto-Dominion Bank)

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