



2 Stocks Targeted by Short Sellers

Description

It always creates an uneasy feeling when one of my favored stocks appears on a short seller hit list. The question immediately springs to mind – what do they know about this company that I may have missed?

Short sellers may take short positions in a stock for a variety of reasons, including an outright negative view on the stock price of a company, hoping for a decline in the stock price. The latest bimonthly report by the Toronto Stock Exchange indicates substantial short positions in the stocks of **Royal Bank of Canada** ([TSX:RY](#))([NYSE:RY](#)) and **Toronto Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)).

Both companies recently published their quarterly results, which provided a good opportunity to assess the key investment risks and to reconsider the valuations on these stocks.

TD Bank reported an adjusted net income of \$2.0 billion for the quarter which was 6% better than the year before and was in line with market expectations. All the major divisions performed well with no serious concerns raised by any of the division heads or the CEO. The balance sheet of TD, which forms the basis of future growth, also reflected solid expansion in loans and deposits and the company increased its dividend.

The valuation of TD Bank does not look expensive compared to its own history and peers. This is a quality operation trading at a 2014 forward price to earnings ratio of 11.8 times, a dividend yield of 3.6% and a price to book ratio of 1.8 times.

Royal Bank reported equally respectable results with an increase in net income of 7% if the loss associated with sale of RBC Jamaica, which has now been sold, is excluded. The Investor and Treasury Services and Capital Markets performed well, wealth management and retail and commercial banking was unchanged or slightly higher, and insurance lagged. The balance sheet reflected reasonable expansion in loans and deposits and the dividend was also increased.

The valuation of Royal Bank does not look expensive either. This is a quality operation trading at a 2014 forward price-to-earnings ratio of 11.9 times, a dividend yield of 3.9% and a price-to-book ratio of 2.1 times.

Based on my assessment, the quarterly results did not provide any meaningful reason to take a short position in the stocks and neither do the current valuations support it. So why do the short sellers hold these positions?

Banks face numerous risks, including a multitude of operational, credit, market, liquidity, reputational and legal risks. Although certainly not foolproof, one has to assume that the risk management framework in place at the better quality banks, which are also overseen by regulators, will do a reasonable job in managing and containing these risks.

However, there are certain risks that come with the territory of doing banking business and although it can be managed, it cannot be avoided. One such risk facing all the major banks in Canada is a major correction in the Canadian real estate market. Both TD Bank and Royal Bank hold massive real estate lending portfolios.

In the case of TD Bank, residential loans amount to \$261 billion of which 56% is insured against default. The total equity capital of TD Bank is \$54 billion. In the case of Royal Bank, residential mortgages amount to \$210 billion with additional home equity lines of \$46 billion. A total of 46% of the residential mortgage book is insured against default but the home equity loans are not insured. The total equity capital of the Bank is \$52 billion. It takes no mathematics genius to work out the damage that a sharp decline in the real estate market can do to these banks.

Foolish bottom line

Short selling activity creates a level of unease among holders of the stocks being shorted but it also provides a good reason to review and question your motivation for holding the stock.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:RY (Royal Bank of Canada)
2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:RY (Royal Bank of Canada)
4. TSX:TD (The Toronto-Dominion Bank)

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Date

2025/07/03

Date Created

2014/03/14

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